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B.Com [Computer Applications]

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AUDITING

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INTRODUCTION

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Given the current business climate that demands high accountability and transparency, the process of auditing has acquired growing importance. The genesis of the economic recession that has the entire world in its throes lies in financial irregularities committed by some US companies. In India too, the 'Satyam' disaster and other such cases have underscored the need for stringent auditing of business firms. It is, therefore, imperative for aspiring auditors to be fully familiar with the processes and practice of auditing.

Whenever, we think about auditing, a picture of an examination comes to our mind which is basically designed to detect the frauds and errors occurred in an organization. Truly speaking, yes, audit is an examination, but not to detect only the frauds and errors but to help the organization to prepare the financial statements containing the financial information (e.g. balance sheet, profit and loss account, etc.), which exhibits a true and fair view of the financial position of the entity under consideration. Here, true and fair view has an extensive meaning as given in the Companies Act.

This book titled, *Auditing*, provides a comprehensive and inclusive study of the subject of auditing as it is practised in the Indian context along with the laws and regulations that govern it.

This book, *Auditing*, has been designed keeping in mind the self-instruction mode (SIM) format and follows a simple pattern, wherein each unit of the book begins with the Introduction followed by the Objectives for the topic. The content is then presented in a simple and easy-to-understand manner and is interspersed with Check Your Progress questions to reinforce the student's understanding of the topic. A list of Self-Assessment Questions and Exercises is also provided at the end of each unit. The Summary and Key Words further act as useful tools for students and are meant for effective recapitulation of the text.

BLOCK I
INTRODUCTION OF AUDITING

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UNIT 1 INTRODUCTION TO AUDITING

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1.0 INTRODUCTION

A company makes various financial decisions that need to be based on correct financial information. Suppose you run a company that requires a loan from a bank. The bank will first require you to furnish the financial records of your company. These will consist of the balance sheet, which will detail the expenditure and income of the company. It will take into account the assets and liabilities of the company in order to reflect a true picture of the company in financial terms. A company needs to conduct a process called audit in order to evaluate its financial status and prepare a balance sheet.

1.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the definition and features of auditing
- Describe the difference between auditing and accountancy
- Examine the scope of auditing

- Discuss the objectives of independent audit
- Assess the concept of efficiency audit and cost audit
- Discuss techniques of audit and the concept of audit evidence

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1.2 AUDITING: DEFINITIONS AND FEATURES

The word 'audit' has been derived from the word 'audire' (Latin), meaning 'to hear' or 'give credence to'. In ancient times it was the practice to check the accounts of an estate, domain or manor by having such accounts called out by those who compiled them. Ever since control and accountability for money was entrusted to third parties, it became necessary to account for the transactions and subject them to some sort of an independent checking. The momentum of the independence was further accelerated with the emergence of the concept of 'limited liability' and the growth of joint stock companies with limited liability. This made it all the more necessary for accounts to be subjected to an independent examination, and auditing, in the modern sense of the term, became an integral part of business. The creditors' need for information on liquidity and *long-run stability (because of the limited liability enjoyed by the proprietors) and of the shareholders for information on stewardship and profitability (because of the day-to-day control by the directors*) necessitated the need for and as a justification for published audited information.

The English Joint Stock Companies Act of 1844 contained provisions for the preparation of a 'full and fair' balance sheet and presentation to every ordinary meeting of the shareholders. It also provided that the audited balance sheet should be filed with the Registrar of Joint Stock Companies. The joint Stock Banking Act of 1844 also required banking companies to provide the annual balance sheet and profit and loss account and for an annual audit.

The first professional society of accountants and auditors was formed under a Royal Charter in Glasgow in 1854. The English Companies Act of 1862 formally recognized the auditor's role for the first time. Towards the close of the 19thcentury, there was a spate of case laws relating to the responsibilities of the auditors vis-à-vis financial reporting. In India, the Companies Act of 1913 provided for an annual compulsory audit of every joint stock company. Qualifications for company auditors were also laid down. The Indian Accounts Board was established in 1932. With the enactment of the Chartered Accountants Act of 1949, autonomy was granted to the accountancy profession.

Till the 1950s, the main objectives of auditing centred a round detection and prevention of fraud and errors. Since that time, fundamental changes in the concept and objectives of an audit have taken place. The emphasis shifted from detection and prevention of fraud and errors to reporting on the 'true and fair' view of the published financial statements. This change reflected not only the need for a broader approach to audit and the importance of an independent opinion on

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the financial statements but also the increasing importance of internal control procedures. By encouraging the development of sound internal control procedures, the auditor's approach to auditing became less of detailed vouching and often somewhat mechanical checking of the transactions of the client, and turned more to employee procedures designed to test the operation of internal control mechanisms.

The establishment of professional accounting bodies in a number of countries and the recommendations made by them from time to time have contributed towards setting new trends in auditing. Changing social attitudes have also gradually brought about a consensus that enterprises of significant size have wider obligations to such groups as employees, consumers and the general public to supply reliable information.

Definition of Audit

An Introduction to Indian Government Accounts and Audit, a book by the Comptroller and Auditor General of India, considers audit as an instrument of financial control. It states that:

> It (audit) acts as a safeguard on behalf of the proprietor (whether an individual or a group of persons) against extravagance, carelessness or fraud on the part of the proprietor's agents or servants in the realization and utilization of his money or other assets, and it ensures on the proprietor's behalf that the accounts maintained truly represent facts and that expenditure has been incurred with due regularity and propriety.

The preface to International Auditing Guidelines of the International Federation of Accountants describes an audit as: 'The independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon.'

The Institute of Chartered Accountants in England and Wales in its 'Statement on Auditing' has stated that the essential features of an audit are:

(a) To make a critical review of the system of book keeping, accounting and internal control;

(b) To make such tests and enquiries as the auditors consider necessary to form an opinion as to the reliability of the records as a basis for the preparation of accounts;

(c) To compare the profit and loss account and the balance sheet with the underlying records in order to see whether they are in accordance therewith;

(d) To make a critical review of the profit and loss account and the balance sheet in order that a report may be made to the members stating whether, in the opinion of the auditors, the accounts are presented and the items are described in such a way that they show not only a true but also a fair view and give in the prescribed manner the information required by the Act.

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The purpose of the work of the auditors is to enable them to express an opinion as to whether the accounts presented show a true and fair view. The purpose should govern their whole approach ... and if in any material they are unable to satisfy themselves, it will be their duty to include appropriate reservations in their report, to the extent, if necessary, of stating that they are not able to express the opinion that the accounts show a true and fair view.

1.3 ACCOUNTANCY AND AUDITING

As already pointed out, an audit is an independent examination of the books, accounts and records of a business with the primary object of enabling the auditor to express an opinion on the financial statements in accordance with the terms of his appointment. Thus an audit is primarily concerned with financial statements which have already been prepared. Accounting is basically concerned with the actual recording of transactions in the books of account and other records of the organisation and the preparation of the financial statements.

Accountants sometimes act in the capacity of both accountants and auditors in the sense that they prepare the accounts and subject them to an independent examination. This is all the more so in the case of clients other than limited companies. In such cases the distinction between the work of accounting and the work of auditing is of vital significance. This is because some clients who do not realise the distinction between the terms 'accounting' and 'auditing' use the terms indiscriminately. This may have far reaching consequences involving questions of negligence and misfeasance as in Smith Vs Sheard, Wilde & Others Vs Cape and Dagleish, etc. Hence it is of utmost importance for a practising accountant to have the terms of his appointment clearly defined in writing. Of course, in the case of statutory audits this question does not arise since the auditor's duties will be clearly defined in the relevant statutes, and any disputes as to the scope of his work will not normally arise, except where the statutory duties have been extended by an agreement.

Apart from the question of negligence or misfeasance, there is another important reason why accounting and auditing work should be kept separate. One of the basic principles governing an audit is that an auditor should both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. Where a firm of accountants acts in the capacity of both accountants and auditors for the same client, independence in mental attitude which is closely connected with integrity and objectivity is likely to be threatened in relation to the audit of financial statements for the preparation of which the same firm (Or, the same accountant) has been responsible. As a natural corollary to this, where the auditor is identified with the client as a result of his indirect participation in the management of the client's business through the supply of book keeping and accountancy services or any other non audit services, then the value of the opinion expressed through the audit report and hence the credibility of the accounts might be impaired.

Of course, sometimes this combination becomes unavoidable in which case it would be advisable to adopt the following steps:

(a) train the audit staff appropriately and make sure that they fully realise the importance of maintaining independence in mental attitude;

(b) divide the accounting and auditing work among entirely different sets of personnel. Wherever possible (especially in the case of larger accountancy firms) set up specialist departments;

(c) use different sets of standard working papers and working paper references for each type of work.

In this connection the observations made by the International Federation of Accountants are pertinent. According to the Federation, "the preparation of accounting records is a service which is frequently requested, particularly by smaller clients, whose businesses are not sufficiently large to employ an adequate internal accounting staff. It is unlikely that larger clients will need this service except in exceptional circumstances." It continues to state that where an accountant is concerned in the preparation of accounting records for an audit client, the following requirements should be observed:

(i) there should not be any relationship or combination of relationship between the accountant and the client which would impair the accountant's integrity and objectivity;

(ii) the responsibility for the statements must be fully that of the client;

(iii) the accountant must not assume the role of employee or of management conducting the operations of an enterprise;

(iv) staff connected with the preparation of accounting records should not participate in the audit of such records.

It further emphasises the point that the fact that the accountant has processed or maintained certain records does not eliminate the need to carry out sufficient audit tests. As a matter of fact, any failure to carry out all normal and sufficient audit procedures will reflect not only on his competence but also on his objectivity.

1.4 SCOPE OF AUDITING

The scope of an audit is dependent on the terms of agreement between the auditor and the client and on statutory requirements and the requirements of the relevant professional bodies. A properly conducted audit is organized to cover adequately all aspects of the organization as far as they are relevant to the financial statements subject to examination. The auditor has to ensure that information contained in the underlying accounting data and other source data is reliable and sufficient as the basis for the preparation of the financial statements.

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As to the point whether the relevant information is properly communicated, the auditor bases his opinion by:

(a) Comparing the financial statements with the underlying accounting records and other source data to see whether they properly summarize the transactions and events recorded therein; and

(b) Considering the judgments that management has made in preparing the financial statements; accordingly he assesses the selection and consistent application of accounting policies, the manner in which the information has been classified, and the adequacy of disclosure.

It may be noted in this connection that the auditor is not responsible for preparation of the financial statements on which he has to form and express an opinion. This is the responsibility of the management of the particular organization concerned which, inter alia, also covers the maintenance of adequate accounting records and internal controls, the selection and application of appropriate accounting policies and the safeguarding of the assets of the organization.

Non-Auditing Services

It would not be out of place to mention certain non-auditing services performed by auditors for their clients. Apart from book keeping and accountancy work including the preparation of final accounts, these services are:

(a) Taxation services such as agreement of tax computation, tax planning and tax negotiations

(b) Secretarial services such as filing statistical and other returns

(c) Financial advice such as advice on loan facilities, preparation of cash budgets, etc.

(d) Management and systems advice such as the provision of advice on accounting systems

(e) Liquidation and receivership services

(f) Investigations including that relating to acquisitions

(g) Negotiations on sale of business

Documents Used for Audit

The broad, general documents used for audit are:

- Letter of engagement
- Summary of appropriate statutory provisions governing the accounts and audit of the client business
- Rules and regulations of the client business
- Copies of documents and minutes of relevance to the audit
- Address of registered office, factories, branches and all other premises with a short description of the business carried out at each place

- An organization chart or brief notes on the organization of the business
- The client's internal accounting instructions and internal audit instructions, including, where appropriate, stock taking instructions
- Notes of interviews and correspondence relating to internal control matters together with all past internal control letters
- Internal control questionnaires
- A list of the client's advisors such as bankers, stockbrokers, solicitors, insurance brokers, etc.
- Copies of letters where the client gives permanent instructions to supply the auditor with any information requested by him
- A list of the client's properties and investments, together with notes of verification
- A list of insurance effected by the client

NOTES

1.4.1 Objectives of Independent Audit

The auditing of company records by third party is called independent audit. Other terms used for independent auditors include external auditors. These are auditors who are not part of the company and are professionals who are hired specifically for such tasks. It helps in companies avoiding conflicts of interest. The following are the goals and objectives of independent audit:

· Inspecting the financial statements of the companies to ensure the adherence to tax and companies' law. It is also done to confirm the accuracy of recording and reporting of financial transactions. It also helps in comparing the books of the company with their financial reports.

· Offering recommendations to the companies regarding their financial activities highlight their areas of improvement and areas with flaws which can be corrected for better performance in the future.

· Offer specialized advice for example, some companies hire independent auditors to achieve specific tasks like ensuring that their financially compliant with the law under risk management practices or help companies review the information they already have under assurance services. Many companies specifically hire independent auditors to check for fraud or embezzlement activities that might be going on in the company, others hire auditors for advice on tax matters.

Check Your Progress

1. State the fundamental changes in the concept and objectives of an audit since the 1950s.
2. What is accounting basically concerned with?
3. What is the scope of auditing dependent on?

1.5 EFFICIENCY AUDIT

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Efficiency audit is a very essential tool that is used to evaluate the efficiency and performance of the various departments of an organization. The concept of efficiency audit is based on basic economic principles. The efficiency and performance of the top management of an organization is based on the following elements of efficiency audit:

- To make sure that there is an adequate rate of return on investments.
- To make sure that the planning of the organization is done in such a manner that optimal efficiency is achieved.

Parameters of Measuring Efficiency Audit

There are various parameters for measuring efficiency, which are:

- Utilization of the various resources of the organization such as men, machine and material.
- Utilization of other types of resources such as financial, physical and human resources.
- Performance of the organization in terms of imports and exports of products during a financial year.
- Payback period of the organization that focuses on recovering the cost of investments that the organization has incurred in various projects.

Organizational Set-up of Efficiency Audit

An organization must develop a well-defined organizational structure if it wants to implement efficiency audit in its work environment. The various important aspects that the organization must keep in mind while implementing efficiency audit are:

- The outlook and the motive of the top management of the organization behind introducing efficiency audit in its work environment.
- The delegation of authority and responsibility to the various departments of the organization in order to implement the efficiency audit.
- The functions of the various departments of the organization must be well defined.
- The organization must recruit efficient, experienced and well-educated individuals.

According to B.H. Walley, 'Efficiency auditing recommends certain breakdown of functions.'

Table 1.1 shows the various roles of efficiency audit in the formation of the organizational structure and their functions.

Table 1.1 *Formation and Functions Organizational Structure*

Functional Head	Roles and Responsibilities
Auditor (Internal)	The main function of auditor (internal) is to look after the general and internal auditing systems of the organization.
Auditor (Management)	The main function of auditor (management) is to check the efficiency of the line and staff management of the organization.
Principal Budget Officer	The main function of the principal budget officer is to prepare the budget of the organization and take effective steps to correct the budget plan, if there is any deviation in the budget.
Investment Appraiser	The main function of the investment appraiser is to appraise or assess the investment that is made by the organization in the various projects and also evaluate the progress of the projects.
Corporate Planner	The main function of the corporate planner is to formulate short- and long-term plans with regard to product sales, product marketing and channels of distribution.
Treasurer	The main function of the treasurer is to prepare the cash budget of the organization.
Operation Research Head	The main function of the operation research head is to oversee whether the resources of the organization such as men, materials and machines are functioning effectively or not.
Line Manager	The main function of the line manager is to look after the various methods of the organization such as planning and control, cost control and cost reduction methods.

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1.6 COST AUDIT

Cost audit is the process of ascertaining whether the production, marketing and sales processes of a business are managed in the most cost-effective way or not. Cost audit as a tool of management of an organization helps in identifying weaknesses in the cost accounting system of the organization. It also acts as a reviewer of the activities of various departments of the organization and pinpoints towards the departments that are inefficient and not working effectively. Therefore, cost audit is an essential tool through which the overall performance of an organization is judged.

According to the Institute of Cost and Management Accountants, London, 'Cost audit is the verification of the correctness of cost accounts and the adherence to the cost accounting plan.'

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According to the Institute of Cost and Works Accountants of India, 'Cost audit is an audit of efficiency, of minute details of expenditures while the work is in progress and not a post mortem examination. Financial audit is a "fait accompli". Cost audit is mainly a preventive measure, a guide for management policy and decision, in addition to being a barometer of performance.'

Therefore, cost audit includes:

- Verifying whether or not the cost accounts of the organization are correct according to the various standards of cost audit.
- Verifying the cost accounting system of the organization including the various records and documents according to the various provisions of the Indian Company Law.

Objectives of Cost Audit

The objectives of cost audit can be analysed with the help of two objectives, which are:

- General objectives
- Social objectives

1. General Objectives

The general objectives of cost audit contain the following important points:

- To discover if the cost accounting system that the organization is following is correct or not.
- To detect frauds in the cost accounting records of the organization.
- To confirm whether the organization is formulating the cost accounting records according to the standards of the cost audits.
- To calculate the exact value of the finished goods produced by the organization.
- To ascertain the total cost incurred by each department of the organization.
- To determine the inefficiency and deficiency of material, machines and labour of the organization.
- To compare the costs with the planned cost of the organization and determining whether the costs that are planned will be achieved or not.

2. Social Objectives

The social objectives of cost audit are those objectives that help the organization in producing quality goods at low prices, controlling the level of inflation and improving the overall structure of the organization with the help of high productivity. The social objectives of cost audit can be attained in the following manner:

- **Increasing Productivity**: The productivity of an organization can be increased with the help of efficient and optimal utilization of various resources

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of the organization such as men, material and machines. Cost audit helps management of the organization in verifying the deficiencies in the various resources so that effective steps can be undertaken in order to rectify the deficiencies and improve the productivity.

- **Identifying Uneconomic Product Line**: Cost audit helps the organization in ascertaining that type of products, which are uneconomic and unprofitable for the organization.
- **Cost Consciousness in both Public and Private Sectors**: Apart from the private sector it is also necessary for the public sector to maintain cost records. When both the public and the private sectors maintain cost records, then it creates cost consciousness among them regarding the utilization of the various financial, physical and human resources.
- **Benefit to Consumers**: According to the Institute of Cost and Works Accountants of India (ICWAI), 'Cost audit aims at increasing the added value through increased profitability per unit of input or resources. This added value can be shared by all the participants and certainly part of the benefit may reasonably be expected to be passed down to the consumer by way of reduced prices'.
- **Price Fixation and Price Control Mechanism**: In order to fix proper prices for a product under a scheme of price control, the government relies very much on the audited statements of cost audit.

Distinction between Cost and Financial Audit

There is a great deal of difference between cost and financial audit. Table 1.2 shows the difference between cost and financial audit.

Table 1.2 *Differences between Cost and Financial Audit*

Cost Audit	Financial Audit
Cost audit is an examination of the overall operations of an organization.	Financial audit is the process of examining the books of accounts of an organization at the end of each year.
The purpose of cost audit is to certify whether the expenditure incurred on the production of products has been incurred properly or not.	The purpose of financial audit is to report on the profit and loss account and the balance sheet of the organization so as to determine whether they reflect the true and fair picture of the organization's financials.
It checks the cost efficiency of the various departments of the organization such as production, marketing and finance.	It analyses whether or not proper procedure is being followed for the development of books of accounts of the organization.
Cost audit is not compulsory for all the organizations. Cost audit is compulsory only in the case of manufacturing or mining companies if they have been specifically asked by the central government to maintain cost accounts under Section 128 of the Companies Act, 2013 and get those accounts audited under Section 148b of the same Act.	Financial audit is compulsory for those organizations that are registered under the Companies Act, 2013.

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Cost audit is done at the requirement of third parties like government and industrial organizations.	Financial audit is conducted at the requirement of the shareholders.
Cost audit may be done in the year in which it is required both by government and by external agency.	Financial audit is conducted periodically in organization.
In cost audit, the auditor has to check the adequacy of the closing stock in view of the needs of the organization.	In financial audit, the auditor has to check the exact value of the closing stock for the purpose of preparing the balance sheet.
The report of the cost auditor is submitted to the organization and also to the central government within 180 days from the end of the organization's financial year.	The financial audit report is submitted to the management, which then presents it in the general meeting of the shareholders of the organization.
It serves the interest of management and the government.	It serves the interest of the shareholders of the organization only.
It helps the government and the organization in fixing the prices of the products.	It does not help in the fixation of prices of the products.
It is product oriented.	It is organization-oriented.

1.7 TECHNIQUES OF AUDIT AND AUDITING STANDARDS

By the term 'standard' we mean the degree of excellence required to achieve a particular objective. It may be defined as a measure accepted by an authority or by general consent, to which one is expected to conform and in relation to which a performance can be judged. Viewed in this light, an auditing standard is a measure of the degree of excellence that an auditor is expected to conform and which measure is laid down by professional bodies with the consent of the independent auditing community in general. For example, the statement that 'due professional care is to be exercised in the performance of the examination and the preparation of the audit report' is an auditing standard. Again, 'sufficient competent evidential matter is to be obtained through inspection, observation, enquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under consideration' is another auditing standard.

By the term 'techniques of auditing' we mean the basic methods to be adopted or the acts to be performed by an auditor for collecting and evaluating audit evidence. C.A.Moyer* has distinguished auditing standards and auditing techniques thus:

"Auditing standards are criteria or measures of performance. Auditing techniques are the devices or methods available to the auditor for obtaining competent evidential matter. They are the working tools of the auditor."

Thus while techniques of auditing refer to the acts to be performed by an auditor, standards in auditing refer to the degree of excellence of these acts and of the objectives to be achieved by the use of these techniques. In short, standards in auditing provide the basis for acceptance of various audit techniques as Standard Auditing Practice.

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Techniques and procedures: In selecting a particular auditing technique, special attention will have to be paid to two important points, viz., (i) the peculiar characteristics of the assertion in the books of account, documents, statements, etc. to be reviewed, and (ii) the nature of evidence available in support of that assertion. With the development in the scope of auditing, the changes in the methods of maintaining the books of account and the growth in the complexities of circumstances in which business enterprises operate there is a need to update auditing techniques on an ongoing basis. Examples of the more important auditing techniques may be summarised as under:

(a) Physical verification.

(b) Observation.

(c) Enquiry and Confirmation.

(d) Examination of documents and their comparison with records.

(e) Computation.

(f) Analytical Review.

1.8 AUDIT EVIDENCE

As already indicated, the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures. The term 'audit evidence' in this context refers to information obtained by the auditor in arriving at reasonable conclusions on which he bases his opinion on the financial statements. Sources of such audit evidence include the accounting system and underlying documentation of the entity, its tangible assets, its management and employees, its customers, its suppliers, and other third parties who have dealings with, or knowledge of, the entity or its activities.

Sufficient Appropriate Audit Evidence

Sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency implies the measure of the quantity of audit evidence obtained; appropriateness implies the relevance and reliability of audit evidence. Normally, the auditor finds it necessary to rely on evidence that is persuasive rather than conclusive. It may become necessary for him to obtain evidence from different sources or of a different nature in support of the same assertion or conclusion.

The audit evidence should, in total, enable the auditor to form an opinion on the financial statements. In forming such an opinion it is neither feasible nor possible for an auditor to examine each and every item of the information available to him.

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The usual procedure is to select a few representative items or transactions or events. Here the auditor will have to exercise his professional judgment after a careful study of the circumstances in the particular case in deciding as to what may be considered as sufficient appropriate audit evidence necessary to achieve the required level of assurance. You will learn more about Audit evidence in Unit 4.

Check Your Progress

4. For whose requirement is cost and financial audit done?
5. Mention the points which need special attention while selecting a particular auditing technique.

1.9 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Since the 1950s, the fundamental change in the concept and objective of an audit has been that the emphasis has shifted from detection and prevention of fraud and errors to reporting on the 'true and fair' view of the published financial statements.
2. Accounting is basically concerned with the actual recording of transactions in the books of account and other records of the organization and the preparation of the financial statements.
3. The scope of an audit is dependent on the terms of agreement between the auditor and the client and on statutory requirements and the requirements of the relevant professional bodies.
4. Cost audit is done at the requirement of third parties like government and industrial organizations while financial audit is conducted at the requirement of the shareholders.
5. In selecting a particular auditing technique, special attention will have to be paid to two important points, viz., (i) the peculiar characteristics of the assertion in the books of accounts, documents, statements, etc., to be reviewed, and (ii) the nature of evidence available in the support of that assertion.

1.10 SUMMARY

- The word 'audit' has been derived from the word 'audire' (Latin) meaning 'to hear' or 'give credence to'.
- The momentum of independent checking, the concepts of limited liability, and the emergence of joint stock companies made auditing an integral part of business.

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- Till the 1950s, the main objectives of auditing centred around detection and prevention of fraud and errors. Since that time, fundamental changes in the concept and objectives of an audit have taken place.
- The emphasis shifted from detection and prevention of fraud and errors to reporting on the 'true and fair' view of the published financial statements.
- The purpose of the work of the auditors is to enable them to express an opinion as to whether the accounts presented show a true and fair view.
- An audit is primarily concerned with financial statements which have already been prepared. Accounting is basically concerned with the actual recording of transactions in the books of account and other records of the organization and the preparation of the financial statements.
- The scope of an audit is dependent on the terms of agreement between the auditor and the client and on statutory requirements and the requirements of the relevant professional bodies.
- The auditors also provide certain non-auditing services like taxation, secretarial, financial, management and negotiation services among others.
- Efficiency audit is a very essential tool that is used to evaluate the efficiency and performance of the various departments of an organization. The concept of efficiency audit is based on basic economic principles.
- Cost audit is the process of ascertaining whether the production, marketing and sales processes of a business are managed in the most cost-effective way or not.
- Techniques of auditing refer to the acts to be performed by an auditor, standards in auditing refer to the degree of excellence of these acts and of the objectives to be achieved by these techniques.
- Examples of techniques of auditing include physical verification, observation, computation, analytical review, etc.
- The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures.
- The audit evidence should enable the auditor to form an opinion on the financial statements.

1.11 KEY WORDS

- **Auditing:** It refers to the independent examination of financial records of a firm.
- **Efficiency audit:** It is an essential tool of audit that is used to evaluate the efficiency and performance of the various departments of an organization.
- **Cost audit:** It is a tool of management of an organization which helps in identifying weaknesses in the cost accounting system of an organization.

- **Audit evidence:** It refers to the information obtained by the audit in arriving at reasonable conclusions on which he bases his opinion on the financial statements.

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1.12 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. List the essential features of an audit.
2. What is the purpose of the work of the auditors?
3. How does the audit base his opinion to the point whether the relevant information is properly communicated?
4. List the non-auditing services performed by auditors.
5. What are the parameters of measuring efficiency audit?
6. Differentiate between cost and financial audit.
7. List some of the important auditing techniques.
8. Write a short note on audit evidence.

Long Answer Questions

1. Write a short note on the evolution of auditing.
2. Discuss the differences between accounting and auditing.
3. Describe the organizational set-up of efficiency audit and the various roles of efficiency audit in the formation of organizational structure and their functions.
4. Explain the objectives of cost audit.

1.13 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

Shekhar, L and K C Shekhar. 2003. *Auditing, 20th edition*. Delhi: Vikas Publishing House.

Prakash, Jagdish. 2014. *Auditing: Principles, Practices and Problems*. New Delhi: Kalyani Publishers.

UNIT 2 INTERNAL CHECK

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Structure

2.0 Introduction
2.1 Objectives
2.2 Internal Control
2.2.1 Elements of Internal Control
2.2.2 Limitations of Internal Control
2.3 Internal Audit and Operational Audit
2.4 Procedure for Implementing Accounting Control
2.5 Comparison of Internal Audit and Independent Financial Audit
2.6 Answers to Check Your Progress Questions
2.7 Summary
2.8 Key Words
2.9 Self Assessment Questions and Exercises
2.10 Further Readings

2.0 INTRODUCTION

One of the important responsibilities of an audit is the evaluation of internal controls. But what is internal control? Let us try and understand it. When you get out of your car, you always make sure that it is locked. This is a kind of internal control that you personally follow in your daily life. You keep your keys, cash and credit cards safely in your purse. It is an internal control to ensure that your valuable things. You also take the shortest or quickest route to the workplace – an internal control that promotes operational efficiency. As with people, organizations also practise internal controls and checks to provide reasonable assurance and achieve objectives – these are actions taken by the management of a company to manage risk and enhance the chances that established objectives and goals will be achieved.

2.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the elements of internal control
- Examine the concept of internal audit
- Discuss the limitations of internal control
- Describe the procedure for implementing accounting control
- Compare the concepts of internal audit and independent financial audit

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2.2 INTERNAL CONTROL

Internal control can be defined as a process, effected by an organization, board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objective in the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations (Committee of Sponsoring Organizations – COSO).

With the growth in the size of business organizations and the increased realization of the fact that the primary responsibility of running an organization and preparing its accounts is that of the management, the importance of instituting proper systems of controls within the organization has received the attention of all concerned. Internal control' is meant not only internal check and internal audit, but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of an entity in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records.

The auditor, in forming his opinion on the financial statements, needs reasonable assurance that the accounting system is adequate, that transactions are properly processed and recorded in the accounting records, and that significant transactions have not been omitted. Such assurance is usually drawn from a combination of reliance on certain internal controls and the performance of substantive procedures. As observed by the International Auditing Practices Committee:

> "The auditor should study and evaluate the accounting system and internal controls to identify those controls on which reliance may be placed and then determine the nature, extent and timing of other audit procedures to be used. This approach normally results in more effective auditing than can be accomplished through a large volume of detailed work."

Herein lies the importance of internal control under contemporary audit practices.

2.2.1 Elements of Internal Control

Now that we have understood what internal control is and its significance, let us study it in detail. There are three divisions of the elements of internal control:

1. **Organizational Structure:** This involves the separation of an organization's operations into appropriate divisions and subdivisions, the appointment of persons to assume responsibility therefore, the establishment of clear lines of responsibility between each division and subdivision and the top management (e.g., Board of directors), and overall coordination of the organization's activities. It should be remembered in this connection that the organizational structure of an entity serves as a framework for the direction and control of its activities and that an effective structure provides for the

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communication of the delegation of authority and the scope of responsibilities. Equally important is the fact that proper functioning of any system depends on the competence and honesty of those operating it. It naturally follows that the qualifications, selection and training as well as the personal characteristics of the personnel involved are important features in a system of internal control.

2. **Authorization, Recording and Custody Procedures:** (with regard to the separation of duties which would, if combined, enable one individual to record and process a transaction from beginning to end). The objects of financial accounting control procedures are to ensure that the funds and the property of the organization are kept under proper custody and may not be improperly applied, either by error or intent; that expenditure may be incurred only after proper authorization, and is properly accounted for; and that all revenues are properly accounted for and received in due course. These objectives can be achieved through a suitable division of duties, the establishment of an appropriate accounting system and the institution of forms of internal check, segregating incompatible functions. Functions are considered to be incompatible which, if combined, would enable one individual to record and process one transaction from beginning to end and hence may permit the commitment and concealment of frauds and errors.

   In devising internal control measures for the establishment of an appropriate accounting system, the following objectives should be kept in mind:

   (i) Execution of transactions is carried out strictly in accordance with management's general or specific authorization;

   (ii) There is prompt recording of all transactions in their correct accounts and in the accounting period to which they relate;

   (iii) Access to assets is permitted only in accordance with management's authorization and approval;

   (iv) There is routine checking from the records to the relevant assets themselves at reasonable intervals and appropriate action is taken to resolve satisfactorily any discrepancies.

   Specific internal control procedures designed to achieve these objectives could include checking the arithmetical accuracy of the records; the maintenance and checking of totals, reconciliations, control accounts and trial balances; physically inspecting stocks, investments and cash balances and comparing them with accounts, records, etc; comparison of results with budgets; etc.

3. **Managerial Supervision and Reviews (including internal audit):** This involves the review by top management of an organization's financial operations and position at regular intervals by means of interim accounts, reports, operating summaries, and other appropriate financial and statistical information. Comparison with results for previous periods may indicate

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discrepancies which call for further examination and explanation. Budgetary control and standard costing systems will be additional tools of internal control. These will assist in revealing material variances which, in turn, could be investigated and satisfactorily resolved. Special reviews by top management of particular items such as stock in trade, or the operations of the wages department and other departments of importance constitute another tool of control.

2.2.2 Limitations of Internal Control

No internal control system, however elaborate, can by itself guarantee efficient administration and the completeness and accuracy of the records. In other words, any system of internal control could provide only reasonable assurance that management objectives are achieved. This is because of the following inherent limitations of internal control:

(i) Management usually insists, and justifiably so, that controls should be cost effective, i.e., the cost of operating a control procedure should not be disproportionate to the potential loss due to fraud or error if the control procedure is removed.

(ii) Most of the control procedures are devised in relation to anticipated types of transactions and hence may not be effective in relation to unusual or extraordinary transactions.

(iii) Human errors due to errors of judgment or interpretation, misunderstanding, carelessness, fatigue or distraction may undermine the effective operation control procedures.

(iv) There is the possibility of circumvention of controls through fraudulent collusion with parties outside the entity or with employees of the entity.

(v) There is the possibility that the person responsible for exercising a control could abuse that responsibility, e.g., authorization controls could be abused by the person in whom the authority is vested. Also, management is frequently in a position to override controls which it has itself set up.

(vi) Although it is possible to ensure the competence and integrity of the personnel operating the controls by a proper system of selection and training, there is the possibility that these qualities may alter due to pressure both within and without the organization.

(vii) There is the possibility that control procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.

It may be noted in this connection that the system of internal control to be adopted and the means by which it is to be communicated and implemented vary according to the nature and circumstances of each business. As a practical illustration, one large group of departmental stores, having considered the losses which could arise on stocks ceased to employ their internal auditors on routine stock checks as the expense involved in payment of salaries for such work considerably outweighed the possible stock losses which might arise.

It is true that cash is the most readily convertible of all assets and thus vulnerable to misappropriation. But the fact should not be overlooked that this item forms only a part of an organization's total assets. Hence, equal attention should be given to custody and control procedures involving other forms of assets. Thus physical as well as documentary controls in all these areas are of vital importance.

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Check Your Progress

1. List the three divisions of the elements of internal control.
2. Mention some of the means by which efficiency of managerial supervision and reviews are checked.

2.3 INTERNAL AUDIT AND OPERATIONAL AUDIT

Internal auditing is a tool of managerial control which is aimed at measuring, reviewing and evaluating the effectiveness of other controls.

Meaning, Significance and Importance

Internal auditing is defined as an appraisal activity, independent of other activities, within an organization, for the review of operations as a service to all levels of management. The basic goal of internal auditing is to measure the optimum use of all resources –human, material and financial – in the most efficient way to accomplish the organization's objectives. It strengthens the system of internal control and the way in which it operates.

It may be noted in this connection that for the initial period of internal auditing, the internal audit function was mostly financial in nature concerned with verifying calculations and clerical operations, as opposed to verifying adherence to procedures and internal controls. Some internal audit functions verified hundred per cent of the transactions in this manner with staffing almost man to man with the clerical staff processing the documents. Over the years, however, the scope of internal auditing and the role of the internal auditor have been extended far beyond these traditional boundaries. The definition given by the Institute of Internal Auditors recognises the fact according to contemporary concept of internal auditing, an internal auditor has to go beyond the books of accounts and the underlying records and appraise the quality of performance of various personnel in the organization in carrying out assigned responsibilities. He is not to confine himself to the routine search for clerical errors in accounting documents and rigid adherence to policies and procedures but he has also to conduct an appraisal of the various operational functions on behalf of top management. In other words, of late, there has been a shift in the orientation of internal auditing to include what is sometimes referred to as operational auditing.

Objectives and Scope of Internal Audit

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What transpires from the above process of evolution is that under contemporary practices a wide range of activities is being done by the internal audit department. These activities may broadly be classified as financial and operational audits. Under the former may be included:

(i) a continuous review of internal accounting controls;
(ii) the scrutiny of reports and statements, financial or operating, as prepared for management purposes;
(iii) the ascertainment to the extent to which the assets of the organization are accounted for and safeguarded from losses or damages;
(iv) the examination of balance sheet items, tests of balances and transactions as to their authenticity through appropriate tests; etc.

Under operational audit may be included:

(i) the study and assessment of operating practices to promote increased efficiency and economy;
(ii) the carrying out of audits to determine whether operating objectives, targets and associated control procedures are properly instituted and the degree to which the desired results are achieved;
(iii) the examination and the ascertainment of the extent to which established policies, plans and procedures are complied with;
(iv) the assessment of budgetary standard setting;
(v) the assessment of the level of performance in successfully discharging duties and responsibilities assigned.

Operational Audit

Let's look at the definition of operational audit briefly. Operational audit is concerned with the operating propriety and efficiency of the functional areas of an organization. It takes into consideration (i) inefficient operations both from the time and cost angles and (ii) wastages of resources through lack of propriety in expenses. It is aimed at improving the profitability of the organization and simultaneously at achieving the other organisational objectives.

2.4 PROCEDURE FOR IMPLEMENTING ACCOUNTING CONTROL

Evaluating internal control systems is one of the major responsibilities of internal audit. The procedure for implementing accounting control can be understood through the following stages:

1. Understanding the Accounting System and Related Internal Controls

The auditor commences his evaluation of the system of internal control stated to be in operation in the client entity by reviewing the accounting system and related internal controls. The object at this stage is to gain an overall understanding of the flow of transactions and the specific control procedures to be able to make a preliminary evaluation, and identification of those internal controls on which it might be effective and efficient to rely in conducting his audit. He obtains an understanding of the accounting system to identify points in the processing of transactions and handling of assets where fraud or error might occur. It goes without saying that when an auditor intends to rely on the system of internal control in carrying out the audit, it is at these points that he must be satisfied that internal control procedures instituted by the client entity are fool proof.

It naturally follows that it would be necessary for the auditor to acquire an up-to-date record of the system of internal control in operation. For this he will have to familiarize himself with the following matters:

(i) Nature of the client's business, place of its activities, methods of production, materials used, processes involved, methods of marketing, involving possibly an inspection of its physical assets and operations

(ii) System of bookkeeping and accounting

(iii) Duties of the members of staff and the division of responsibilities

(iv) Internal check system in force

(v) Internal audit arrangements

The review as above consists mainly of enquiries of personnel at various organizational levels within the client entity, together with reference to procedures manuals, job descriptions and flow charts. The object obviously is to gain knowledge about the controls which the auditor has identified as significant to his audit. At the time of the first audit the auditor will have to make extensive enquiries to ascertain the system. In a continuing engagement, he will be aware of internal controls through work carried out previously; but even then, he will need to update his knowledge. It may be noted in this connection that a review of the kind mentioned above will give the auditor an awareness of the physical realities behind the book entries and records which he examines and will enable him to consider their significance more intelligently.

At this stage the auditor will be in a position to make a tentative decision as to whether he could probably rely on internal controls for the purpose of his audit. If he decides favourably, his next task will be to identify and document the various internal control measures. The auditor makes use of a number of techniques to document information concerning the control system. Common techniques used alone or in combination include narrative descriptions, internal control questionnaires and flow charts.

It is important for the auditor to make enquiries in order to ensure that the internal controls were in use throughout the accounting period in an uninterrupted manner. If substantially different controls were used at different times during the period, it would be necessary for the auditor to consider each separately. A breakdown of control measures for a specific portion of the period of intended reliance would necessitate separate consideration of the nature, timing and extent of the audit procedures to be applied to the transactions of that period.

2. Preliminary Evaluation

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A review as above will enable the auditor to identify tentatively the particular controls on which it is reasonable for him to rely for the purpose of his audit. It may be noted in this connection that on the basis of the review as above the auditor may conclude that it is not reasonable to rely on particular controls because they are either defective in design and/or operation or that the audit effort required to test compliance would exceed the reduction in effort that could be achieved by reliance on them.

3. Testing

The next stage in the evaluation process is to carry out a series of compliance tests in order to gain evidence that those internal controls which the auditor has identified tentatively as reliable for the purpose of his audit operate generally as identified by him and that they function effectively throughout the accounting period in an uninterrupted manner. The concept of effective operation recognizes that some deviations from compliance may have occurred. For instance, changes in key members of staff, significant seasonal fluctuations in the volume of transactions, etc could cause deviations from prescribed controls. It is necessary for the auditor to make specific enquiries concerning such matters and to ensure that the compliance tests performed by him appropriately cover the transactions during such periods.

Some aspects of the internal control system in operation may be tested by direct observation. For example, the adherence to prescribed stock taking procedures can be verified by direct observation by the auditor. In other cases, representative sections of the client entity's records are selected for examination in detail. These, in turn, can be subjected to testing in depth to ensure that transactions are properly authorized, evidenced and recorded.

4. Assessment

On the basis of the results of the compliance tests, the auditor will be in a position to assess whether he could rely on the internal controls for the purpose of his audit. The reliance which is appropriate depends on the level of the auditor's assurance as to the effective operation of the controls.

It is possible that the results of compliance tests indicate that it is not appropriate to rely on a particular internal control to the degree previously contemplated. In that case the auditor should ascertain whether there is any other control which would satisfy his purpose and on which he might rely. In other words, in assessing weaknesses and inadequacies it is important to consider the system as a whole before a final view is formed. This is because an apparent weakness in an individual case may be unimportant when other aspects of the system are considered simultaneously, e.g., if all remittances received are by cheques which are crossed to the bank account of the client business on the opening of post by officials independent of the cashier's department and the sales ledger personnel, failure to maintain a rough cash book need not be considered as a point of weakness. Any conclusions in this regard, however, should strictly be based on the results of appropriate compliance tests.

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In performing compliance tests, it is important to select transactions representing the whole accounting period under review. It is possible that the auditor selected a shorter period for performing initial compliance tests. In that case he should consider what is necessary to provide reasonable assurance as to the reliability of the accounting records for the whole period. It may be mentioned in this connection that in arriving at a judgment as to the nature, timing and extent of compliance or substantive tests to be performed to transactions occurring in the remaining period, the auditor should take into consideration the following factors:

(a) Results of the tests already performed
(b) Response to enquiries as to whether the internal control system is still operating in the same manner as originally reviewed and evaluated
(c) Length of the remaining period
(d) Auditor's evaluation of the internal control environment, especially supervisory controls
(e) Extent of substantive tests which the auditor intends to perform irrespective of the adequacy of internal controls

Reporting Internal Control Weaknesses – Letter of Weakness, Internal Control Letter, or Management Letter

Any weaknesses or defects in the system of internal control or areas where there is scope for improvement (discovered during the course of performing compliance tests) should be reported to the appropriate personnel and the facts placed on record. It is preferable for the auditor to arrange an interview with the appropriate personnel to discuss the weaknesses and the recommendations for improvement. Following this, a letter usually termed 'Internal Control Letter' or 'Letter of Weakness' or 'Management Letter' should be sent. This letter should set out the weaknesses along with recommendations for improvement and any action agreed to be taken. It is important to point out in this letter that the weaknesses reported are only those which have come to the attention of the auditor during his examination of the system of internal control and that, consequently, they are not necessarily the only weaknesses that exist in the system. This will have the effect of making the management realize that the primary responsibility for establishing and maintaining an adequate system of internal control rests with them. The letter should be concluded with a direction to intimate the auditor of the steps taken by the management to remedy the weaknesses, or improvements made in the system. Internal Control Letters so sent to the management will not, however, absolve the auditor from discharging his responsibilities to state clearly the facts in his report.

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It may be repeated here that in exceptional cases the auditor may find that the records and the system of internal control are so seriously inadequate that no useful purpose could be served by embarking upon any extent of detailed checking because even the most detailed and exhaustive tests would not enable him to form an opinion on the financial statements. In that event the appropriate course will be to state the facts in his report and to inform the management of the respects in which the records and the system are deficient.

Internal Control Questionnaires

An internal control questionnaire (ICQ) contains questions designed to establish the strength of the system of internal control in operation in the various aspects of an organization's business and to highlight any defects, breakdowns or weaknesses. It also serves as a record of the review of the internal control system.

Check Your Progress

3. State the basic goal of internal auditing.
4. What does operational audit take into consideration?
5. List some of the techniques used by the auditor to document information concerning the control system.
6. What is an internal control questionnaire?

2.5 COMPARISON OF INTERNAL AUDIT AND INDEPENDENT FINANCIAL AUDIT

Although the work of the independent auditor and that of the internal auditor have a number of common features, there are some fundamental differences between the two forms of audit.

Scope: In the case of an independent statutory audit, the duties, responsibilities, rights and liabilities of the auditor are laid down under the respective statutes. For example, the duties, rights, etc. of a company auditor are laid down in the Companies Act. On the other hand, the extent of the work to be undertaken by the internal auditor is mainly determined by the management.

Approach: The internal auditor's approach is with a view to ensuring that the accounting system is efficient and effective so that the accounting information presented to the management throughout the period is accurate and discloses material facts. The independent auditor's approach, however, is governed by his duty to satisfy himself that the accounts to be presented to the shareholders show a true and fair view of the profit or loss for the financial period and of the state of the company's affairs at the end of that period.

Responsibility: The responsibility of the internal auditor is towards the management. Whereas, the independent auditor is responsible directly to the shareholders.

Independence: As a natural corollary to the above, the independent auditor has got an independent status, while the internal auditor, being an employee of the organisation, does not possess this independence of status.

Cooperation between the Independent Auditor and the Internal Auditor

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In spite of the important differences enumerated above, and bearing in mind the fact that the professional responsibility of the independent auditor for the expression of his opinion is sole and indivisible, there are a number of areas where the independent auditor and the internal auditor could cooperate gainfully. Because of the experience gained in public practice, the independent auditor may be of assistance in an advisory capacity in connection with the installation and the subsequent operation of an internal audit department; and in carrying out his duties he may derive much assistance from the internal auditor's intimate knowledge of the business, particularly in connection with stock in trade and work in progress, the physical existence of fixed assets, depreciation charges, the ascertainment of liabilities, and the risks of fraud and misappropriation.

Unnecessary duplication of work can also be avoided wherever reasonable and practicable, thus reducing the work which the independent auditor performs himself. This is all the more true in view of the fact that on accounting matters the independent auditor and the internal auditor operate largely in the same field and they have a common interest in ascertaining that there is:

(a) An effective system of internal check to prevent and/or detect errors and fraud and that it is operating satisfactorily; and

(b) An adequate accounting system to provide the information necessary for preparing true and fair financial statements.

More specifically, the work of both the independent auditor and the internal auditor is carried out largely by similar methods in such areas as given below:

- Examination of the soundness and effectiveness of internal check.
- Examination and checking of accounting records and statements.
- Verification of assets and liabilities.
- Observation, enquiry, the making of statistical comparisons and other measures as may be judged necessary.
- Performance of detailed examinations of balances and transactions.

In order to determine whether and to what extent the independent auditor might be able to rely on the work performed by the internal auditor, the former should ascertain the extent to which such work has been done with objectivity, competence and due professional care by the latter. In other words, the quality of the internal audit personnel, their degree of independence, their work performance and scope of the internal audit function are important factors which should receive the attention of the independent auditor. These are further elaborated in the following paragraphs.

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Quality of the Internal Audit Personnel

In ascertaining the quality of the internal audit personnel, the independent auditor should enquire into the following:

(a) The qualifications and technical training of the internal audit personnel. In some cases both the internal auditors and the independent auditors belong to the same professional organisation and are subject to the same professional regulations except for independence.

(b) The client's practices for the recruitment and training of the internal audit personnel.

(c) The extent of supervision provided by the chief internal auditor, including the supervision on planning, monitoring progress, assessing conclusions reached, reviewing reports and following up to ensure that recommendations accepted are carried out.

(d) The standing of and regard for the abilities of the internal audit personnel in the client organisation.

Degree of Independence of the Internal Auditors and the Objectivity with which the Work is Performed

The independent auditor should ensure himself that the internal auditor is in a position to perform his work with a satisfactory degree of independence and objectivity. In assessing this the independent auditor should satisfy himself that the internal auditor reports or has access to the highest levels of management. In such a case he is likely to be more objective than when he reports to lower levels of management. The nature and extent of any constraints placed on the work of the internal auditor by management should carefully be considered by the independent auditor. A review of the findings and recommendations contained in the reports of the internal audit personnel will usually be a useful factor in judging their independence and objectivity.

Scope of the Internal Audit Function

The independent auditor should evaluate the work performance of the internal audit personnel by examining and reviewing documentary evidence of their work. He should examine the actual contents of the assignments with which the internal audit personnel are being charged by management. He should then ensure that those assignments which have a bearing on his work have been performed with due professional care. He should do the following:

(a) Examine the audit programmes chalked out by the internal audit personnel to ensure that they are adequate enough to enable the assignments to be conducted in a timely and adequate manner. Such programmes should preferably be chalked out in cooperation with independent auditors.

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(b) Examine the relevant minutes, reports, Internal Control Letters, etc. issued by the internal audit department so as to form an opinion as to the validity of the conclusions set out in such documents, wherever possible, comparing such conclusions with his own findings based upon his examination and evaluation of the same or similar transactions, balances or procedures.

(c) Examine the extent to which and the promptness with which the recommendations issued by the internal audit department are considered and implemented by the management.

In addition to the above, it is necessary for the independent auditor to test the work of the internal audit personnel by doing the following:

(i) Examining some of the transactions or balances checked by the internal audit personnel;

(ii) Examining similar transactions and balances checked by the internal audit personnel and comparing the results of such tests with the conclusions reached; and

(iii) Reviewing the programme of work papers and reports of the internal audit personnel.

Based on the outcome of the examination, review and assessment on the above lines, the independent auditor should decide on the nature and extent of his reliance on the work of the internal auditors. In some cases, it would be possible for him to reach a conclusion that audit work which he would normally expect to carry out himself may be carried out by the internal auditors.

Possible Areas of Cooperation and Coordination

Although it is not possible to lay down any hard and fast rules as to the exact areas of cooperation and coordination between the independent auditor and the internal auditor, the following general considerations may be pointed out in this respect. Of course, these considerations depend solely on the extent of appropriate evidence gathered by the independent auditor to arrive at a conclusion that reliance may be placed on the work performed by the internal auditor.

1. The finalisation of the audit programme could be done through mutual consultation. The audit of the day to day proceedings and routine work could be carried out by the internal auditors according to the audit programme. After an examination and review of the working papers, reports, etc. of the internal auditors, if the independent auditor is satisfied as to the accuracy of the work carried out, unnecessary duplication of work could be avoided.
2. Testing of a small volume of repetitive transactions could be allocated to internal auditors.
3. A digest of all matters decided during the year or pending in courts of law or other authorities at the yearend could be made by the internal auditors so

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that the extent of contingent liabilities could be verified and suitable provisions made in this respect. This could help in expediting the finalisation of the independent auditor's work.

4. Verification of cash balances both at the head office and at the various branches could be done by the independent auditor and the internal auditor visiting them either jointly or by dividing the work. So also, physical verification of stock in trade and work in progress could be organised by the independent auditor and the internal auditor. The internal auditor could prepare, classify, analyse, evaluate and verify detailed inventories, indicating therein the method of valuation and noting for obsolete, damaged and slow moving items. This could be test checked by the independent auditor.
5. In the same way, detailed schedules prepared for debtors, creditors, bank balances, etc. giving therein the addresses and the respective age of each item along with their comments could be verified by the internal auditors. By mutual agreement the letters could be posted by the internal audit department directing the parties concerned to confirm the correctness of the accounts direct to the independent auditor. The main items could be test checked by the independent auditor.
6. Working and other schedules in respect of the control figures appearing in the financial statements could be verified by the internal auditors. The independent auditor could test check and verify the main items.

In this connection, the observations made by the Institute of Chartered Accountants in England and Wales may be noted,

> 'The internal auditor's responsibility is to the management and he is in no sense a servant to the independent auditor. It follows therefore that the extent to which the internal auditor can so arrange his work as to be of specific assistance to the independent auditor will depend on the decisions of the management on the scope of the internal audit and the number of staff employed thereon. Consultation between the two auditors, and where necessary with the management, should however, ensure that so far as is practicable the fullest possible assistance is available to the independent auditor.'

At the same time it is of importance to remember that judgments relating to material aspects of the financial statements as well as the audit thereof must inevitably be those of the independent auditor. Such aspects include:

(a) the effectiveness of the internal accounting control;

(b) the sufficiency of audit tests performed;

(c) the materiality of transactions;

(d) the accounting principles applied, including their disclosure and presentation;

(e) any risks and uncertainties which may have been brought to light in the course of the audit.

In these areas the independent auditor will have to carry out himself all such work as he considers to be essential in forming his own personal judgment.

Documentation

Whenever the independent auditor relies on the work carried out by the internal audit department, the same should be properly documented along with the reasons supporting the decision. Such documentation should include the examination and assessment on the quality of the internal audit personnel, the degree of their independence and the objectivity with which work is performed, the scope of the internal audit function, and also the details of any specific tests of transactions, balances or working papers. Besides, the extent of the internal audit work to which the independent auditor has relied and the conclusions arrived at should be documented.

Scope of the Internal Audit Function

The independent auditor should evaluate the work performance of the internal audit personnel by examining and reviewing documentary evidence of their work. He should examine the actual contents of the assignments with which the internal audit personnel are being charged by management. He should then ensure that those assignments which have a bearing on his work have been performed with due professional care. He should:

(a) Examine the audit programmes chalked out by the internal audit personnel to ensure that they are adequate enough to enable the assignments to be conducted in a timely and adequate manner. Such programmes should preferably be chalked out in cooperation with independent auditors.

(b) Examine the relevant minutes, reports, Internal Control Letters, etc issued by the internal audit department so as to form an opinion as to the validity of the conclusions set out in such documents, wherever possible, comparing such conclusions with his own findings based upon his examination and evaluation of the same or similar transactions, balances or procedures.

(c) Examine the extent to which and the promptness with which the recommendations issued by the internal audit department are considered and implemented by the management.

In addition to the above, it is necessary for the independent auditor to test the work of the internal audit personnel by

(i) examining some of the transactions or balances checked by the internal audit personnel;

(ii) examining similar transactions and balances checked by the internal audit personnel and comparing the results of such tests with the conclusions reached; and

(iii) reviewing the programme of work papers and reports of the internal audit personnel.

Based on the outcome of the examination, review and assessment on the above lines, the independent auditor should decide on the nature and extent of his reliance on the work of the internal auditors. In some cases, it would be possible for him to reach a conclusion that audit work which he would normally expect to carry out himself may be carried out by the internal auditors.

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Check Your Progress

7. What is the difference in the orientation of responsibility when it comes to internal and independent auditor?
8. Mention some of the areas in which the internal auditor's knowledge of business is particularly useful for the independent auditor.

2.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. There are three divisions of the elements of internal control: organizational structure, authorization, recording and custody procedures, and managerial supervisions and reviews.
2. Managerial supervisions and reviews involve the review by top management of an organization's financial operations and position at regular intervals by means of interim accounts, reports, operating summaries, and other appropriate financial and statistical information.
3. The basic goal of internal auditing is to measure the optimum use of all resources — human, material and financial— in the most efficient way to accomplish the organization's objectives.
4. Operational audit takes into consideration (i) inefficient operations both from the time and cost angles; and (ii) wastage of resources through lack of propriety expenses.
5. The auditor makes use of a number of techniques to document information concerning the control system. Common techniques used alone or in combination include narrative descriptions, internal control questionnaires and flow charts.
6. An internal control questionnaire (ICQ) contains questions designed to establish the strength of the system of internal control in operation in the various aspects of an organization's business and to highlight any defects, breakdowns or weaknesses.
7. The responsibility of the internal auditor is towards the management whereas, the independent auditor is responsible directly to the shareholders.
8. Some of the areas in which the internal auditor's knowledge of business is particularly useful for the independent auditor include stock in trade, work in progress, the physical existence of fixed assets, depreciation charges, the ascertainment of liabilities, and the risks of fraud and misappropriation.

2.7 SUMMARY

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- 'Internal control' is meant not only internal check and internal audit, but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of an entity in an orderly manner safeguard its assets and secure as far as possible the accuracy and reliability of its records.
- There are three divisions of the elements of internal control: organizational structure, authorization, recording and custody procedures, and managerial supervisions and reviews.
- Limitations of internal control include costs, inability to judge unusual events, human errors, fraudulent collusions, integrity of the personnel, etc.
- Internal auditing is defined as an appraisal activity, independent of other activities within an organization, for the review of operations as a service to all levels of management.
- Over the years, the scope of internal auditing and the role of internal auditor have been extended far beyond the traditional boundaries.
- The contemporary activities of internal auditing may be broadly classified as financial and operational audits.
- Operational audit is concerned with the operating propriety and efficiency of the functional areas of an organization.
- Evaluating internal control systems is one of the major responsibilities of internal audit. The procedure for implementing accounting control can be understood through the following stages: Understanding the Accounting System and Related Internal Controls, Preliminary Evaluation, Testing, and Assessment.
- Any weaknesses or defects in the system of internal control or areas where there is scope for improvement (discovered during the course of performing compliance tests) should be reported to the appropriate personnel and the facts placed on record.
- It is preferable for the auditor to arrange an interview with the appropriate personnel to discuss the weaknesses and the recommendations for improvement. Following this, a letter usually termed 'Internal Control Letter' or 'Letter of Weakness' or 'Management Letter' should be sent.
- There are fundamental differences between the independent and internal audit on account of scope, approach, responsibility and independence.
- In spite of the differences, there are a number of areas where the independent auditor and internal auditor could cooperate gainfully.
- In order to determine whether and to what extent the independent auditor might be able to rely on the work performed by the internal auditor, the former should ascertain the extent to which such work has been done with objectivity, competence and due professional care by the latter.

2.8 KEY WORDS

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- **Internal control:** It can be defined as a process, effected by an organization, board of directors, management and other personnel, which is designed to provide reasonable assurance regarding the achievement of objective in the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.
- **Internal auditing:** It is a tool of managerial control which is aimed at measuring, reviewing and evaluating the effectiveness of other controls.
- **Operational audit:** It is concerned with the operating propriety and efficiency of the functional areas of an organization.

2.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the limitations of internal control systems?
2. What are financial and operational audits?
3. Briefly explain the possible areas of cooperation and coordination between independent and internal auditor.
4. List the aspects in which the judgements of the independent auditors is important.

Long Answer Questions

1. Describe the elements of internal control.
2. Explain the procedure for implementing accounting control.
3. Examine the factors which affect the cooperation between independent auditor and internal auditor.

2.10 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

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UNIT 3 VOUCHING

NOTES

Structure

3.0 Introduction
3.1 Objectives
3.2 Vouching and Types of Vouchers
  3.2.1 Vouching of Cash Book and Transactions
  3.2.2 Vouching of Impersonal Ledger
  3.2.3 Verification of Documentary Evidence and Methods of Window Dressing
3.3 Answers to Check Your Progress Questions
3.4 Summary
3.5 Key Words
3.6 Self Assessment Questions and Exercises
3.7 Further Readings

3.0 INTRODUCTION

One important aspect of auditing is vouching. Vouching, in fact, considered the backbone of the audit process. Vouching may appear to be similar to routine checking but they are two different functions. While routine checking is merely concerned with the verification of the arithmetical accuracy of the entries, vouching is more than the mere examination or comparison of the vouchers with the entries in the books of account.

In this unit, you will first study about the meaning and importance of vouching and then discuss the various types of vouching, that is, vouching for cash payments, cash receipts, purchases and sales.

3.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the meaning of vouching
- Discuss the importance of vouching
- Describe the vouching of cash book and trading transactions
- Examine the vouching of impersonal ledger, cash transactions, verification of documentary evidence and methods of window dressing

3.2 VOUCHING AND TYPES OF VOUCHERS

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Vouching refers to the examination of vouchers with a view to authenticating and supporting the transactions recorded in the books. Thus, it involves comparing entries recorded in the books with the relevant and appropriate vouchers. According to F R M De Paula, 'vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of the transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized and are correctly recorded in the books'. Again, Arthur W Holmes defines vouching as, 'Vouching is the examination of the underlying evidence which is in support of the accuracy of the transaction. The process of vouching is intended to substantiate an entry by providing authority, ownership, existence and accuracy'.

It is of utmost importance that the auditor should exercise due professional care and skill in carrying out vouching tests. It should be clearly understood that such tests are performed to ensure the following:

- Transactions are recorded in the correct amount.
- Transactions are appropriately authorized – 'appropriate' to the levels of the relevant transactions.
- Transactions have occurred in the accounting period under review.
- Transactions represent items compatible with the needs of the client business, i.e., they fall within the purview of the normal activities of the client business.
- Transactions represent items acquired for the purpose of the business and not for the personal benefit of any of the employees.
- There is arithmetical accuracy in calculations, extensions, casts, etc.
- There is appropriate allocation between capital and revenue.
- There is evidence that vouchers comply with internal checking and control procedures. Such evidence may consist of initials, rubber stamp, signature, etc on vouchers concerned.

Although vouching occupies a very important place in auditing, under the contemporary 'systems based' audit it is not the usual practice to resort to extensive vouching tests except in the following cases:

- In the case of organizations where the system of internal control is not satisfactory.
- In the case of small organizations where it is not practicable to achieve a proper segregation of incompatible functions because of limited number of staff.

- In the case of organizations which carry on specialized activities where although the number of transactions is limited most of them are of considerable value and material significance.
- In the case of transactions which are specialized in nature and limited in number such as share capital, major items of capital expenditure, sales and purchases of investments, investment income, directors' remuneration, commission paid to agents and salesmen, etc.

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Importance of Vouching

Vouching is not the mere examination or comparison of the vouchers with the entries in the books of account. It is much more than that. It is such an examination of the entries in the books of account as will satisfy the auditor that the entries are not only supported by the vouchers but also they took place as stated, that they have been duly authorized by a competent official, that they properly related to the business and that they have been recorded in the books in conformity with accepted principles of accounting. Vouching is the essence or 'backbone' of auditing and it is one of the most important tools in the hands of the auditor. It is the foundation upon which the very superstructure of auditing stands. An entry may appear to be innocent; but unless the auditor goes beyond the books and trace the very source it will not be possible to ascertain the truth and genuineness of the transaction.

As observed earlier, the auditor has to go beyond establishing its arithmetical accuracy. He/she has to ensure that the entry is accurate, duly authorized by an appropriate official, relates to the period under review and properly relates to the business. For instance, a fictitious payment may have been entered in the books in order to misappropriate money, or the payment may be genuine but not on account of the business, or it may not relate to that accounting year. Herein lies the importance of vouching with professional care and skill. The observation of the learned judge in Armitage vs Brewer and Knott that "it was clear that a good many documents were suspicious on their face and called for an enquiry" brings out the importance of vouching with due And reasonable care by an auditor. In this case, the auditors were found guilty of negligence for their failure to display enough reasonable care and skill in vouching wages sheets and ending up in their failure to detect fraud in manipulation of the wages records and cash vouchers.

Routine Checking and Vouching

Routine checking consists of checking of casts, subcasts, carry forwards, extensions, calculations, etc in subsidiary books, checking of postings into the ledger, casting of ledger accounts, extraction of the balances, etc in the books of original entry, the checking of postings to the ledgers, the checking of ledger accounts in relation to their casts, balancing the carrying forward of balances and the transfer of balances to the trial balance. Normally this work is assigned to junior members

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of the audit staff. Routine checking is done with the principal objective of verification of the arithmetical accuracy of the entries with a view to ascertaining the accuracy of the postings to the ledgers, checking the ledger accounts and ascertaining the correct balancing and to make sure that there has been no alterations in the figures once the checking has been completed. As against this, the objects of vouching are much wider in scope. Besides the objects of routine checking mentioned above, vouching is done with the object of going behind the books and satisfying that the transactions recorded in the books of account are appropriately authorized and correctly entered into, thereby finding out facts behind the figures. Simple routine checking cannot establish the same accuracy which vouching can. The extent of vouching to be carried out by an auditor is dependent on the systems of accounting and related internal controls.

Types of Vouchers

A voucher is documentary evidence in support of a transaction recorded in the books of account. There are different types of vouchers such as an invoice, a supplier's statement, correspondence, an insurance policy, a certificate from a third party, a statement from a debtor confirming the balance due, etc. Specific examples of types of vouchers in respect of the following items are given against each item:

- **For cash payments:** Receipts from payees, invoices, wages book, contracts, confirmation by creditors, etc.
- **For cash receipts:** Counterfoils of the receipts issued, correspondence with the relevant parties, etc.
- **Purchases:** Invoices, Goods Inward Book, copies of orders, correspondence with suppliers, etc.
- **Sales:** Copies of invoices, correspondence with purchasers, Goods Outward Book, etc.

3.2.1 Vouching of Cash Book and Transactions

Before we learn about these specific types of vouchers, let's discuss the process of vouching of Cash Book and Trading Transactions.

Vouching of Cash Book

The vouching of the cash book is done by considering the items on its debit and credit sides. Some examples of transactions included for this purpose include opening balance, cash sales and cash payments, sale of fixed assets, loans received, receipts of bill discounted and bills matured, etc.

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Table 3.1 *Vouching of Items of Cash Book*

Items of Debit Side	
Items	**Vouchers to Be Checked**
Opening Balance	Last Audited Balance Sheet
Cash Sales	Duplicate Cash memos, Salesman's Abstracts and Summaries of Cashiers
Cash Receipts from Debtors	Counterfoils, correspondence etc.
Receipts of Bills Receivables	Bills Receivable Book, Cash Book and Pass Book
Rent receivables	Lease Deeds and Agreements, Counterfoils, Correspondence, Rent Rolls, etc.
Commission Received	Counterfoils and Agreements
Income from Interest	Counterfoils, Agreements and Pass book
Income from Dividend	Counterfoils, Pass book and Dividend Warrants
Loans	Value of Security offered, Agreement and legal provisions
Sale of Investments	Broker's sold note and Bank Advice
Bad Debts Dividends	Counterfoils
Subscriptions Received	Counterfoils and Registrations of Subscriptions
Insurance Claim Money	Accounts and Correspondence
Share capital	Partnership Deed
Sale of Fixed Assets	Auctioneer's Nots, Sale Deed, Correspondence and Broker's Note
Income from Hire Purchase Agreement	Agreement and Counterfoils
Items of Credit Side	
Items	**Vouchers to be Checked**
Payment to Creditors	Receipts, Creditors Accounts
Payment of Salaries	Attendance record, appointment letter, Comparison of Present and Last Month's Amounts, Alterations in Deductions
Payment of Wages	Wage Sheet, Wage Register, Comparison across months, Checking for Fictitious or Ex-workers
Purchase of Fixed Assets	Purchase Invoice, Installation, Freight charges, Treatment of Excise Duties, Lease Agreements
Rent Payment	Rent Deed, Receipts from landlords, provision for Unpaid rent
Insurance Premium	Insurance Policy, Premium Receipt
Income Tax	Advance Tax Challan, Assessment order, Self-Assessment Challan, Income tax Demand Notice
Commission on Sale	Agreement of Sale, rate of Commission, Cash receipts, Provision of Commission Payable
Director's Fees	Attendance register, payment receipts

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The following points should be kept in mind while undertaking the vouching of Cash book:

- Check for the internal check system in place
- Verify the system of accounting followed
- Conduct Test Checking
- Compare rough and final cash books
- Verify cash in hand
- Prepare Bank reconciliation statement
- Ensure that a proper control system for receipts book is in place.

Vouching of Trade Transactions

The vouching of cash transactions is followed by the vouching of trade transactions. Trade transactions are nothing but transactions like purchase, purchase returns, sales and sales return.

Table 3.2 *Vouching of Items of Trade Transactions*

Items	Things to be Checked
Vouching of Purchase Book	Record of all purchase orders, Purchase Invoice, Purchase Order, Purchase Bills, Statement of Accounts of Suppliers
Vouching of Purchase Returns Book	Debit Note or Purchase Return Invoice, Credit Note from Supplier, Goods return Book
Vouching of Credit Sale	Sale Order Register, Dispatch Challan, Sales Invoice, Sales Book, Outwards Register, Payment terms, Trade Discounts
Vouching of Sales Return	Sales return Register, Goods Inwards register, Credit Note, Store Records, Customer Account

Some of the following points should be kept in mind while vouching for trade transactions:

- Valuation of current assets is not over the required
- Fictitious assets should be written-off
- Correctly check the stock in trade and verify the reason for any discrepancy
- Careful segregation and valuation of capital and revenue items so as to avoid over and under profit valuation of the company

Now that you have learnt the brief context of vouching of cash book and trade transactions. Let's study some of the important types of vouchers.

Let us study how the above types of vouchers and how they are vouched.

1. Vouching of Receipts

As you read in the last section, vouchers may of different types. Let us see how vouching is done for these:

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Vouching of receipts from cash sales: The procedure for recording receipts from cash sales is the most important factor in deciding the required evidence for vouching cash sales. The auditor should check carbon copies of the cash memos or cash sales invoices with reference to the entries in the books of account. Where automatic cash tills are used, summaries should be checked. Enquiries should be made on the basis of charging prices to the customers against each sale and documentary evidence in this connection should be examined. Based on the system of internal control in operation (the details of which are given in Unit 3), the extent of test check with the goods outward book should be decided and carried out accordingly.

Usually, a junior member of the audit staff reads out the contents of the voucher such as number of the voucher, its amount, etc. The senior auditor compares every item stated in the vouchers with entries in the books. Various ticks or symbols, which are code words, are used to clear the items checked. Vouchers are stamped with 'cancelled' stamp, or initial/signature is used to signify cancellation in order to avoid presentation of the same voucher in support of another entry. For missing vouchers/doubtful entries, the word 'Q' is made against such missing vouchers/doubtful entries and the same is recorded in the audit working papers. Explanation is sought from relevant officials. Based on the explanation, the auditor will decide whether the same is satisfactory. Unsatisfactory replies are rejected and details of explanation and causes of rejection are noted down in the audit working papers. The auditor will try to make use of other available evidence to verify the truth and resolve the issue.

Vouching of receipts from debtors: Examine the method of allowing discount to customers. Any unusual discount allowed should be noted and a satisfactory explanation from a responsible official should be obtained.

- Check the carbon copy of the receipt issued to the debtor/counterfoil of the receipt with reference to the cash book.
- Ensure that the custody and issue of the receipt books is in the hands of a responsible official.
- Ensure that the official responsible for handling remittances received from debtors has no responsibility in connection with the preparation and sending out of statements to debtors.
- Ascertain whether the bearer/order cheques are deposited in the bank.

Vouching of bills receivable: Compare cash receipts from bills discounted or matured with reference to the Bills Receivable Book, Cash Book and bank pass book/statement, ensuring that all matured bills have been accounted for. Make enquiries concerning bills receivable which are due for receipts of cash but against which cash has not been received. A certificate should be obtained from an authorized person that payments on such bills have not been received. The matter should be further investigated to ensure that there is no misappropriation.

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Vouching of proceeds from sale of investments: The usual procedure for the sale of investments is through brokers. Entry in the books of account concerning the details of the amount received from the sale, commission paid to the broker, etc should be compared with the broker's sold note. In case there is any agreement or correspondence in relation to the sale, the same should also be examined. Sometimes, the investment has been sold cum-dividend in which case it should be ascertained that the relevant dividend has been received and apportioned between capital and revenue. Where the sale is ex-dividend, the relevant entry should be examined.

Vouching of proceeds from the sale of buildings: Where the sale is through a broker, the proceeds of the sale should be vouched with reference to the note of the broker. Where a sale deed or contract is the medium, the relevant entry should be vouched with reference to the deed or contract.

2. Vouching of Payments

Vouching of payments can be in different forms:

Cash purchases: This can be done as follows:

- Vouch payments for cash purchases with reference to cash memos of the suppliers.
- Goods Received Notes and all available documentary evidence evidencing the receipt of goods should be checked to ensure that goods have actually been received.
- Verify allocation to the head of account debited.

Vouching of payment to creditors: The following steps need to be taken:

- Ensure that invoices have been internally checked and initialed by authorized officials.
- Ensure that payments are authorized by appropriate officials.
- Check the cash book to ensure that the name of the payee is correctly stated in the cash book.
- Ensure that the amounts of payments and the head of account debited are correctly recorded in the cash book.
- Ascertain that the dates in the payee's acknowledgements agree with the corresponding entries in the cash book.
- Scrutinize statements of the creditors.

Vouching of bills payable: The following steps need to be taken:

- Check the bills paid during the period with reference to the cash book and bills returned.
- Check the total bills not matured and ensure that they agree with the credit balance on the bills payable account in the edger.

- Check the postings of the bills payable. Also, check the casts, cross casts and carry forwards.

Vouching of purchase of building: The following steps need to be taken:

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- Examine the documents of title to the property.
- Ascertain whether the building is purchased on freehold or leasehold basis. Where it is purchased on leasehold basis, ascertain the terms of the lease.
- Where it is purchased in an auction, examine the account submitted by the auctioneer.
- Where it is purchased through a broker, examine the broker's note.
- Where it is purchased direct from the seller, check the correspondence in relation thereto.
- Vouch auctioneer's commission, brokerage, registration fees and legal charges, etc with reference to receipts obtained. Simultaneously ensure that the same have been capitalized.

Vouching of purchase of plant and machinery: Where plant and machinery are purchased from a vendor, the invoice from the vendor and the receipt for payment towards the cost of the asset should be examined. Simultaneously proper enquiries should be made to ascertain that the items included under this head are bonafide capital charges including cost of carriage and erection. Where plant and machinery are bought in an auction, the auctioneer's statement of account should be examined. Where they have been purchased under hire-purchase agreement, the agreement and the relevant vouchers should be examined and ascertain whether proper apportionment is made of the installments paid between capital and revenue. Ensure that repairs and expenses of maintenance are not capitalized. Also, ensure that loss on sale of any obsolete plant and machinery has been treated as revenue loss.

Where plant and machinery are imported, customs duty will have been paid in which case the documents to be checked are: (a) accounts submitted by the clearing agent, (b) deposit account with customs authorities, (c) receipt issued by customs authorities for payments made, (d) statement of duty payable, and (e) other supporting papers and vouchers. It should be ensured that the customs duty paid is in connection with the import of plant and machinery only and that they are purchased for the use of the business concerned. The amount of customs duty should be verified with reference to the bill of entry duly stamped by customs authority. Where plant and machinery are imported through clearing agents, the accounts submitted by the clearing agents should be verified to make sure total charges including customs duty on account of import of the asset. The accounting aspect of customs duty paid against import of machinery should be looked into, viz., that the same has been capitalized by debiting plant and machinery account.

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Vouching of patent rights: The following steps need to be taken:

- Obtain a list of patents and examine it with reference to registration number, date, name of the seller, consideration paid, etc.
- Check the existence of patents, registration certificates, certificates of grant of patents, documents of assignment and receipts for the renewal fees.
- Where patents have been purchased through an agent, ascertain the agent's fees and verify the amounts included in the books of account.
- Ensure that the patent renewal fee has not been charged to the patent account since it is a revenue expenditure.
- Ensure that lapsed patents have been written off from the books of account.
- Ensure that patents have been valued properly and that there is consistency in the method of valuation over the years.

3. Vouching of Deferred Revenue Expenditure

Deferred revenue expenditure is a non-recurring expenditure which is expected to be of financial benefit to several accounting periods. The accounting treatment of an item of deferred revenue expenditure is to allocate it over the financial years during which it is expected to yield benefits for the business. That portion of the deferred revenue expenditure which is not yet written off will be treated as a temporary asset. Research and development expenditure is a typical example of a deferred revenue expenditure. Other examples include plant rearrangement and removing costs; expenditure incurred in connection with the launching of a new product; cost of removal of the business to a more convenient locality; expenses incurred by way of exceptional repairs of non-recurring nature; development expenditure; abnormal advertisement expenses in connection with a heavy sales campaign; etc.

Following are given the procedures to be followed while vouching deferred revenue expenditure:

1. At the very outset, ascertain the nature of the work and it should be ensured that ordinary revenue expenditure is not treated as deferred revenue expenditure with a view to inflating profits.
2. Ascertain whether the concerned activity is authorized by the Board of Directors and has relevance to the objectives of the company.
3. In case the expenditure is for developing new products or for inventing a new product, see that such expenditure is written off over a period of three to five years, if successful. In case it is established that the effort is not going to succeed, see that the entire expenses incurred are written off to the profit and loss account.
4. Ensure that any machinery and equipment have been purchased for the purpose of the concerned activity, the cost thereof less the residual value is

appropriately debited to the account of the concerned activity over the years of the activity.

5. Ensure that no expenses unrelated to the activity are allowed to be debited to the account of the activity.
6. Verify various items of expenses incurred on the activity with reference to supporting documents and related agreements. For instance, the cost of materials consumed may be verified with reference to such documents as purchase invoices, goods received notes, records relating to issue of materials, agreements with third parties, etc.
7. Ensure that the deferral of the expenditure is in accordance with the recognized accounting policies and practices.
8. Check calculations and examine all related vouchers to ascertain the correct amount to be amortized.
9. See that the balance of expenditure not written off is shown on the asset side of the balance sheet until it is fully written off.

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4. Vouching of Preliminary Expenses

Preliminary expenses are the expenses incurred in connection with the incorporation of the company. They include professional charges paid for consultation in incorporating the company; professional charges paid for drafting the Memorandum of Association and Articles of Association of the company; cost of printing Memorandum of Association, Articles of Association, Prospectus, Letters of Allotment, etc; stamp duty for the documents; registration fee paid to the Registrar of Companies for incorporation; cost of advertising the prospectus, etc; cost of company's seal and statutory books; cost of preparing, printing and stamping debenture trust deed, etc; incidental expenses such as stationary, conveyance, etc. Vouch the payments of such expenses by reference to receipts, invoices, bills, etc. Check the receipts issued by the Registrar of Stamps for stamps issued. In addition a photocopy of the relevant document duly attested by a director of the company should be examined.

Preliminary expenses might have been incurred by more than one person. The promoter who incurred the expenditure has to present a statement of expenditure for reimbursement. The supporting documents such as relevant bills and receipts will be attached to such a statement. The auditor should check the expenditure concerned with reference to this statement and the supporting documents attached to it. The minutes of the Board of Directors which quantify the preliminary expenses should also be checked. Reimbursement of preliminary expenses should be checked with reference to the Memorandum of Association and Articles of Association to ascertain whether the relevant clause of reimbursement is contained therein.

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5. Vouching of Underwriting Commission

Underwriting agreement is an agreement between a company and the underwriter, whereby the underwriter agrees to take up the whole or part of the shares/ debentures of the company which may not be subscribed by the public. Underwriting commission is the commission payable to the underwriter for the underwriting agreement. The Companies Act contains provisions regarding the payment of underwriting commission subject to certain conditions. From the point of view of vouching underwriting commission, the more important provisions are: (i) that the payment should be authorized by the Articles of the company; (ii) that the rate of commission should not exceed five per cent of the price at which shares are issued or the rate authorized by the Articles of Association, whichever is less (two and a half per cent in the case of debentures); (iii) no commission should be paid by the company in respect of shares/debentures which are not offered to the public for subscription.

In relation to vouching, the auditor should:

- check the terms of underwriting commission from the Articles of Association, prospectus and the underwriting agreement;
- examine the Articles of Association to ensure that the payment of underwriting commission is authorized;
- ensure that the rate of underwriting commission does not exceed five per cent in the case of shares and two and a half per cent in the case of debentures;
- check the calculations of commission paid and compare the amount with the underwriter's receipt;
- verify the relevant entries where shares are allotted in the shape of commission;
- ensure that the underwriting commission is not included in the general heading 'preliminary expenses', but is shown separately in the balance sheet until written off;
- ensure that the amount not written off is shown distinctly in the balance sheet;
- ascertain whether the underwriting commission remains within the limits laid down by the Controller of Capital issues.

3.2.2 Vouching of Impersonal Ledger

Impersonal ledger consists of transactions which are relevant to the Profit and Loss Account. The original entry for these transactions are usually in the Cash book or other subsidiary books and journals. The following points should be kept in mind with regards to the vouching of impersonal ledger:

- Check the posting of cash transactions
- Tally with journal entry as credible evidence
- The totals of other books of original entry and their consequent posting to the ledger should be tallied.
- Direct entries from accounts should be vouched by each item as mentioned in the journal.
- Posting of year-end adjustments like depreciation, outstanding assets and liabilities should be cross verified from the journals.
- Check the totals of subsidiary books.
- Tally the balance of impersonal ledger with the Trial Balance

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3.2.3 Verification of Documentary Evidence And Methods Of Window Dressing

While vouching is a term associated with transactions, verification is a term associated with assets and liabilities. Verification is concerned with the establishment of the existence, beneficial ownership, completeness and valuation of assets, and the correctness of liabilities as at the date of the financial statements. It is also concerned with the presentation of assets and liabilities in the financial statements, i.e., to ensure whether the presentation is clear and unambiguous, whether it is appropriate to the nature of the business, whether it is in accordance with the relevant statutory requirements and accounting/auditing standards and whether it is consistent with the policies adopted in previous years.

Window dressing refers to the techniques used by companies in which they manipulate the financial statements in their favour to show a false and/or inflated performance. It is deemed illegal and considered to be a form of fraud which impact the investors and their opinions about the firm. There are many ways in which companies manipulate or window dress their accounts:

- Selling off fixed assets with greater depreciation to improve net book value of assets
- Delaying cash payments to ensure that year end balances appear high
- Similarly, postponing supplier invoices for their recording in later periods
- Capitalizing expenditures of smaller amounts to increase profits which would otherwise have been attributed to expenses
- Recording lower expenses of bad debts to show better performance of the accounts receivables
- Offering early discounts for improving the revenue of the current period which otherwise would have reflected in future periods.

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Check Your Progress

1. What does the phrase 'the auditor has to go beyond arithmetical accuracy' while vouching imply?
2. Mention some examples of vouchers for sales.
3. How is that portion of deferred revenue expenditure which is not yet written off treated?

3.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. While vouching, the auditor has to go beyond establishing its arithmetical accuracy. He/She has to ensure that the entry is accurate, duly authorized by an appropriate official, relates to the period under review and properly related to the business.
2. Examples of sales voucher include copies of invoices, correspondence with purchasers, Goods Outward book, etc.
3. That portion of the deferred revenue expenditure which is not yet written off is treated as a temporary asset.

3.4 SUMMARY

- Vouching refers to the examination of vouchers with a view to authenticating the transactions recorded in the books.
- It is important that the auditor should exercise due professional care and skill in carrying out vouching tests.
- Although vouching occupies a very important place in auditing, under the contemporary 'systems based' audit, it is not the usual practice to resort to extensive vouching tests except in certain cases.
- Vouching is the essence or 'backbone' of auditing. It is not the mere examination or comparison of the vouchers with the entries in the books of account. It is such an examination of the entries in the books of account as will satisfy the auditor that the entries are not only supported by the vouchers but also that they took placed as stated, that they have been duly authorized by a competent official, that they properly relate to the business and that they have been recorded in the books in conformity with accepted principles of accounting.
- The objectives of vouching are much wider in scope as compared to routine checking. Simple routine checking cannot establish the same accuracy which vouching can.

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- A voucher is documentary evidence in support of a transaction recorded in the books of account.
- There are different types of vouchers such as an invoice, a supplier's statement, correspondence, an insurance policy, a certificate from a third party, etc.
- The procedures for recording receipts from cash sales is the most important factor in deciding the required evidence for vouching cash sales.
- Vouching of receipts from debtors involves various steps.
- Bills Receivables should be vouched with reference to Bills Receivable Book, Cash Book and bank pass book/bank statement.
- In vouching proceeds from sale of investment, the auditor should pay particular attention to see whether the concerned investment has been sold cum-dividend or ex-dividend.
- Vouching of payment involves vouching of cash purchases, payments to creditors, bills payable and purchase of fixed assets.
- There are various procedures to be followed while vouching deferred revenue expenditure. Same is the case with the vouching of preliminary expenses and underwriting commission.

3.5 KEY WORDS

- **Voucher:** It is a documentary evidence in support of a transaction recorded in the books of account.
- **Vouching:** It refers to the examination of vouchers with a view to authenticating and supporting the transactions recorded in the books.
- **Deferred expenditure:** It is a non-recurring expenditure which is expected to be of financial benefit to several accounting periods.

3.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the reasons for performing vouching?
2. Mention the cases in which extensive vouching tests are done.
3. Briefly explain the importance of vouching.
4. How is routine checking different from vouching?
5. Write a short note on the vouching of cash book and trading transactions.
6. How is the vouching of preliminary expenses done?

Long Answer Questions

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1. Explain the vouching of receipts
2. Discuss the forms of vouching of payments.
3. Describe the vouching of deferred expenditure and underwriting commission.

3.7 FURTHER READINGS

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UNIT 4 AUDIT EVIDENCE AND SAMPLING

NOTES

Structure

4.0 Introduction
4.1 Objectives
4.2 Nature of Evidence
4.2.1 Procedures and Methods
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4.8 Self Assessment Questions and Exercises
4.9 Further Readings

4.0 INTRODUCTION

You were introduced to the concept of audit evidence in Unit 1. It refers to information obtained by the auditor in arriving at reasonable conclusions on which he bases his opinion on the financial statements. Sources of such audit evidence include the accounting system and underlying documentation of the entity, its tangible assets, its management and employees, its customers, its suppliers, and other third parties who have dealings with, or knowledge of, the entity or its activities

4.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the nature of audit evidence
- Discuss the process and methods used for collecting audit evidence
- Examine the concept of audit sampling
- Describe audit tests and test checking
- Discuss the concept of statistical sampling

4.2 NATURE OF EVIDENCE

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The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as:

(a) the auditor's knowledge of the business of the client organisation and the industry in which it operates;
(b) the degree of risk of misstatement through errors or irregularities. This risk, in turn, may be affected by:
    (i) the nature of the item,
    (ii) the adequacy of internal control,
    (iii) the nature of the business carried on by the client organisation,
    (iv) situations which may exert an unusual pressure on the management including possible management bias,
    (v) the financial position of the client organisation;
(c) the materiality of the item in relation to the financial statements taken as a whole;
(d) the experience gained during previous audits as to the reliability of the management and staff of the client organisation and of its records;
(e) the extent of irregularities revealed during the course of performing audit procedures including fraud or error which may have been found; and
(f) material variances in comparative figures of working ratios for the previous years or for similar organisations in the same industry.

Factors to be Considered in Obtaining Audit Evidence

While obtaining audit evidence through the performance of compliance procedures, the following assertions should be given importance:

(a) Existence	—	the control which is supposed to exist actually exists.
(b) Effectiveness	—	the control is operating effectively.
(c) Continuity	—	the control has operated effectively in an uninterrupted manner throughout the period of intended reliance.

While obtaining audit evidence through the performance of substantive procedures, the following assertions should be given importance:

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	Audit Objective	Explanation	The Question to be Answered
(a)	Existence	Existence of an asset or a liability at a given date	Do the recorded assets and liabilities actually exist?
(b)	Rights/Ownership and Obligations	An asset is a right of the entity and a liability is an obligation of the entity at a given date	Are the assets owned by the entity and are the liabilities the obligations of the entity?
(c)	Occurrence	A transaction or event took place which pertains to the entity	Did the recorded income and expense transactions in fact occur?
(d)	Completeness	There are no unrecorded assets, liabilities or transactions	Have all the assets and liabilities been recorded? Have all and expenses been recorded?
(e)	Valuation and Accuracy	An asset or a liability is recorded at an appropriate carrying value	Have the amounts attributed to the assets and liabilities been arrived at in accordance with the stated accounting policies on an acceptable and consistent basis?
(f)	Measurement	A transaction is recorded in the proper amount and revenue or expense is allocated to the proper period	Have the income and expense been measured in accordance with the stated accounting policies on an acceptable and consistent basis? In particular, whether proper allocation is made between capital and revenue?
(g)	Presentation and Disclosure	An item is disclosed and described in accordance with acceptable accounting policies and, when applicable legal requirements	Have the assets, liabilities capital and reserves as also incomes and expenses been disclosed, classified and described in accordance with acceptable accounting policies and, when applicable, legal requirements?

It should clearly be understood in this connection that the auditor will not be justified in obtaining evidence in respect one of the above assertions while failing to do so in respect of another. By way of an example, obtaining evidence in respect of the assertion of EXISTENCE of stock in trade will not justify the auditor for his failure to obtain evidence in respect of other assertions such as VALUATION, COMPLETENESS, PRESENTATION, DISCLOSURE, etc. of stock in trade.

Actions and Events Happening after the Date of the Financial Statements

There are many techniques of obtaining audit evidence. There will be discussed further in this unit, but before that let's discuss the nature of a certain type of audience evidence. An auditor can find evidence for a number of assertions in certain actions and events happening after the date of the financial statements. Examples include subsequent collection of a trade debt, subsequent payment clearing a liability, subsequent determination of the purchase price or of the proceeds of sale of assets purchased or sold before the year end, subsequent insolvency of a debtor, etc. Such actions and events give the auditor the advantage of hindsight.

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At the same time it is important that the auditor should normally take into consideration only those events which help him in judging the validity of assertions made in the financial statements under his audit. The reader's attention is invited to the topic "Events occurring after the Balance Sheet date" where such events are discussed more fully.

Circumstantial Evidence as a Form of Audit Evidence

A brief mention of circumstantial evidence as a form of audit evidence would be pertinent in this connection. It need hardly be stated that the accounting system and the output which it produces in the form of accounting balances constitute the basic supporting evidence for the figures in the financial statements. But the acceptability of this basic evidence depends on the circumstances under which the accounting system operates and the accounting figures are developed. In other words, the system of internal control instituted and implemented by the management is the most significant type of circumstantial evidence in support of the reliability of the accounting system and the output it produces in the form of accounting balances.

It may be noted in this connection that it is not practical to list all forms of circumstantial evidence which may be found useful by the auditor. Briefly it may be stated that common sense, experience and commercial judgment of the auditor will enable him to identify such evidence during the course of his detailed work. Logical, reasonable and consistent gross and net profit margins for the current year as compared to the previous few years might provide evidence as to the reasonableness of the figures included in the financial statements. Of course, it is important that such an evidence should not be taken in isolation in reaching valid final conclusions.

General Presumptions as to the Validity of Audit Evidence

The reliability of audit evidence is influenced by its source (internal or external) and by its nature (visual, documentary or oral). In other words, the reliability of audit evidence in forming an opinion on the relevant financial statements depends on the circumstances under which such evidence is obtained. Hence it would be difficult to make any generalisations about the reliability of various types of audit evidence. Nevertheless the following general presumptions may act as a useful guide in assessing the reliability of audit evidence.

(i) Corroborative evidence obtained from independent sources outside the client organisation provides greater assurance of reliability than evidence secured solely from within the organisation. For instance, statements from individual debtors confirming the amounts of debts, received by the auditor direct, provide for greater assurance of reliability than schedules of debtors prepared by the client staff. Written statements from competent parties outside the organisation confirming the amounts of sundry creditors, bills receivable, bills payable, bank balances, etc. are other examples. Similarly, a statement from the company's lawyer about claims existing against the company in courts of law provides greater assurance of reliability than a statement on contingent liabilities prepared by the client staff.

(ii) When accounting data and financial statements are developed under satisfactory conditions of internal control, there is more assurance about their reliability than when they are developed under unsatisfactory conditions of internal control. In other words, the existence of an efficient and effective system of internal control and its operation throughout the accounting period in an uninterrupted manner provide more reliable internal evidence.

(iii) Evidence obtained by the auditor himself from inspection, observation, computation, etc. is more reliable.

(iv) Evidence in the form of documents and written representations is more reliable than oral representations.

It is possible for the auditor to achieve an increased measure of assurance by obtaining audit evidence from different sources or of different nature in support of the same assertion and ensuring that they are consistent. When the individual items of evidence relating to a particular assertion are all consistent then the auditor could obtain a cumulative degree of assurance than that which he obtains from an individual item of evidence. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, further procedures will have to be carried out to resolve the inconsistency before deciding on the validity of the evidence.

The auditor should be thorough in his efforts to obtain evidence and should be objective in its evaluation. In selecting procedures to obtain evidence, he should recognise the possibility that the financial statements may be materially misstated.

As in all audit procedures, the cost of obtaining audit evidence should bear a rational relationship with the potential benefits or the usefulness of the information received. At the same time, the matter of difficulty and expenses involved in testing a particular item will not justify the omission of a necessary audit procedure. Whenever the auditor is in reasonable doubt as to the reliability of any assertion of material significance, he should carry out the relevant audit procedures to obtain sufficient appropriate audit evidence. If he is unable to obtain sufficient appropriate evidence, his duty is clear and should refrain from expressing an unqualified opinion.

Certificates from Third Parties

As indicated in the previous section, corroborative evidence obtained from third parties outside the client organisation is usually considered to be reliable audit evidence. Hence it is a normal audit procedure to obtain certificates from third parties as verification of items included in the financial statements. Such certificates may be broadly grouped under two categories, viz.,

(i) Certificates as verification of assets held by third parties on behalf of the client organisation.

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(ii) Certificates as verification of amounts due by the client organisation to third parties.

For the certificates obtained from third parties to have value as audit evidence, they should comply with the following principles:

1. Such certificates should be received direct by the auditor in response to his specific request. The auditor should take the necessary precautions to ensure that the requests are mailed or otherwise transmitted to the third parties concerned with no opportunity for the client staff to intercept them.
2. Where the certificates are obtained as verification of assets or title to assets held by third parties, it should be ensured that the third parties are holding them in the normal course of business. For instance, accepting securities for safe custody is one of the subsidiary services rendered by a banking institution in its ordinary course of business. Hence a certificate from a bank in respect of securities held by it for safe custody may be considered as a valid audit evidence. The same remarks apply in the case of a certificate issued by a public warehouse in respect of quantities of goods held by it on behalf of the client organisation. On the other hand, it is not part of the business of stockbrokers or solicitors to hold documents of title for safe keeping. Hence a certificate from a stockbroker or a solicitor in respect of documents of title held on behalf of the client organisation is not prima facie acceptable as audit evidence.
3. In continuation of the above point, it is equally important that before accepting a certificate the auditor should satisfy himself as to the propriety of the situation and the status of the person or institution supplying the certificate. Thus if it is found that a bank, which had furnished a certificate in respect of certain stock exchange securities held by it on behalf of the client organisation was

   (a) not completely independent of the client organisation, or

   (b) not of established reputation, that should put the auditor on enquiry.

   Points (a) and (b) enumerated above have a direct bearing on the remarks made in the City Equitable Fire Insurance Company case. According to the Master of Rolls in this case:

   "...............he (the auditor) must take a certificate from a person who is in the habit of dealing with, and holding, securities, and who he, on reasonable grounds, rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate............."
4. In case a third party holds substantial stocks on behalf of the client organisation, the following line of action is recommended wherever practicable

   (a) Establish by discussion what internal control procedures are in force in the client organisation to investigate and understand the suitability of the third party concerned to hold the client organisation's stock. The internal control procedures instituted by such third party, its financial position, general standing, integrity and insurance cover are the relevant factors to be investigated.

(b) Establish by discussion what continuing procedures are adopted by the client organisation to review the performance of the third party holding the stocks. These should include regular agreement of quantities between the client's records and the statements from the third party holding the stocks, and physical verification of the items included in stocks wherever practicable or reasonable. It is important that the auditor should test check the procedures stated to be in force in order to ensure that they are being properly implemented.

5. While obtaining certificates from third parties as verification of assets, the auditor should make a specific request to include therein the following information:
   (a) whether the assets were held at the date of the financial statements for safe custody free from lien, or for what other purpose they were held;
   (b) whether there is any interest or other income accrued on the assets concerned at the date of the financial statements.
6. While obtaining certificates from third parties as verification of loans made to the client, the auditor should make a specific request to include therein the following information:
   (a) whether any securities are held in respect of the loan and, if so, the details of such securities;
   (b) whether any interest or any other charge has accrued on the loan at the date of the financial statements.

4.2.1 Procedures and Methods

Audit evidence is obtained through one or more of the following techniques of audit testing. The timing of performing them will be dependent, in part, upon the periods of time during which the audit evidence sought is available.

(a) Inspection: This consists of reviewing or examining records and documents, or physical verification of tangible assets. Inspection of records and documents provides evidence of varying degrees of reliability depending on their nature and source, and the effectiveness of internal controls over their processing. Documentary evidence, which provides varying degrees of reliability to the auditor, may be classified into three different categories. They are:

(i) Documents originating from sources outside the entity but held in the custody of the client at the time the evidence is examined by the auditor, e.g., purchase invoices, insurance policies, etc. These documents are

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generally reliable as audit evidence for the transactions represented by them. But it should be noted that there are variations even within this class of documents. For instance, it is difficult to forge an insurance policy which is issued under closely controlled conditions as compared to a purchase invoice which could more easily be forged or altered.

(ii) Documents prepared inside the entity under audit; but validated by independent sources. Thus in many organisations cheques are prepared inside the organisation but are received by the payees and thus provide a reliable evidence of the payments represented by them.

(iii) Documents created and held by the entity (and used completely within the entity) under audit. These are considered generally of lesser reliability; but if subjected to strong internal control within the client organisation they may nevertheless be quite reliable. A time card authenticated by the personnel department, clocked in and out by the worker concerned under strict supervision of a time keeper would be an example of a document subject to strong internal control, although created and held by the entity. Much less reliable would be a petty cash receipt for entertainment expenses bearing the purported signature of the official who spent the amount. Physical inspection of tangible assets provides reliable evidence with respect to their existence but not necessarily as to their ownership or valuation expressed in money equivalents.

(b) Observation: This consists at looking at an operation or process or a procedure being performed by others with a view to determining the manner of its performance. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trail. It may be noted in this connection that 'observation' provides reliable evidence as to the manner of the performance at the time of observation, but not at any other time.

(c) Enquiry and confirmation: Enquiry consists of seeking relevant information from knowledgeable persons inside or outside the entity. Enquiries may be formal or informal, written or oral. In other words, they range from formal written enquiries addressed to persons outside the entity to informal oral enquiries addressed to persons within the entity. Response to enquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

Confirmation consists of the response to an enquiry to corroborate information contained in the accounting records. For instance, it is a normal auditing procedureto request confirmation of bank balances, debtor balances, etc. by direct communication with the bank, debtors, etc.

An auditor can have strong evidence if an independent party makes a written or oral statement in support of certain facts, provided the auditor is of the opinion that the party has the necessary competence, experience and integrity. Statements from the bank as to bank balances, statements from the client's lawyers as to the extent of contingent liabilities in respect of disputed claims before courts of law, etc. are examples.

In the absence of suspicious circumstances, an auditor can place limited reliance on the statements by officers and employees of the entity. During the course of audit, an auditor often requires the officers and other employees to provide him with detailed explanations and information. Such statements may be formal or informal. While this evidence is not sufficient in itself and cannot be considered as reliable as statements from independent third parties, it is a valuable form of corroborative evidence. In addition, it may disclose situations that require further investigation. Also, some explanations and affirmations can be provided only by the officers and employees of the entity.

(d) ***Computation:*** This consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations. Independent computations made by the auditor often provide an important source of audit evidence.

(e) ***Analytical review:*** This consists of studying significant ratios, trends and other statistics and investigating unusual or unexpected fluctuations and items and expected fluctuations which fail to occur. Various types of ratio changes and trend analyses have become recognised in recent years as important audit tools. Whether the data meet the test of logic, reasonableness and normality is just as significant as whether they are documentary evidence.

Check Your Progress

1. What are the categories of assertions of importance while obtaining audit evidence through the performance of compliance procedures?
2. Mention the categories of certificates from third parties.

4.3 AUDIT TESTS

Audit procedures should be based primarily on an appropriate series of tests designed to satisfy the auditor that the internal control system is properly operating and is effective so that the records can be regarded as a reliable basis for the preparation of the financial statements. It is important to remember that tests of the detailed transactions should be reduced to the minimum taking into consideration the effectiveness with which the system of internal control is in operation as also the nature of the transaction or the item in question. This will help in achieving considerable saving in time and expenses involved in the massive vouching of routine transactions and extensive checking of postings and additions.

The tests referred to above include the following

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Compliance Tests (Procedural Tests)

These are tests which seek to provide audit evidence that internal control procedures are being applied as prescribed. In other words, these are tests carried out to ensure that the procedures laid down are in fact followed. For instance, the system in operation is determined by the auditor through very restricted walk-through tests together with information gathered from the officials of the entity concerned. The system as it appears to be operating is then recorded by him by means of flow charts, narrative descriptions, etc. Now it becomes necessary for him to corroborate that the system is actually operating in the way it has been recorded by him. In other words, it is necessary for the auditor to establish that the system as it operates in practice complies with the system as recorded. Compliance tests are tests which he carries out to establish such compliance. For example, the initial walk-through tests and enquiries of the officials concerned may have indicated that payment of wages is done by persons independent of the preparation of wages sheets and pay packets. This is important evidence of a control procedure and the auditor will be anxious to confirm through compliance testing that it is applied in practice.

It may be pointed out in this connection that compliance tests are performed at any time that the auditor is testing the application of internal control procedures. Most of these tests are performed at the time when the system for processing and recording day to day transactions are being tested. For instance, the tests performed on the application of internal control procedures surrounding the client routines for preparing wages sheets and payment of wages, or for processing and recording purchases and related stock movements, etc. Compliance tests are also performed at the year end date and during final examination. Compliance tests performed on the client's year end stock taking procedures and on the procedures for establishing accruals appearing in the financial statements are examples of such tests.

Sometimes the auditor may come across weaknesses or departures from the prescribed procedures in certain areas during the course of performing compliance tests. In such circumstances he should adopt the following line of action.

(i) make a record of all weaknesses or departures regardless of the amount involved and carry out necessary investigations;

(ii) find out whether the weakness or departure was only an isolated one and whether except for the particular weakness or departure other internal control procedures are being properly implemented;

(iii) confirm the validity of the explanations in respect of the weakness or departure which appears to be an isolated one by performing further tests;

(iv) do not rely on the control in case the weakness or departure indicates that the control was not operating properly in an uninterrupted manner throughout the accounting period;

(v) extend substantive tests in case of indication as in (iv) above;

(vi) qualify the report in case extended substantive testing does not provide the auditor with conclusive evidence of the matter in question.

Walk-through Tests

These are tests carried out by the auditor concurrently with or soon after the preliminary evaluation of the accounting system and related internal controls. It may be made clear here that such tests are carried out only where the auditor has a probable intention to rely on the system of internal control to determine the nature, extent and timing of his substantive tests. The object of such tests is to confirm that there is no reason to suppose that the accounting system and the related internal controls do not operate in the manner they were recorded.

The preliminary evaluation of the accounting system and related internal controls mentioned in the above paragraph consists mainly of enquiries of personnel at various organisational levels within the client organisation together with documentation such as procedures manuals, job descriptions, etc. to gain knowledge about the controls which the auditor has identified as significant to his audit. Once this preliminary evaluation is completed and the auditor has a probable intention to rely on the internal controls it is the normal practice to carry out certain depth tests* to gain a more complete understanding of the system and to ensure whether the information required by him from enquiries, documentation, etc. is correct. Such tests are popularly known as Walk-through tests in auditing circles. In carrying out walk-through tests, the normal procedure is to select at random a small number of basic types of transactions for testing in depth. They need not be representative in the statistical sense.

Walk-through tests should not be confused with compliance tests. They are only an aid to recording the accounting system and related internal controls. It should clearly be understood that satisfactory completion of walk-through tests does not mean that reliance can be placed on the system of internal control. Satisfaction in relation to the system of internal control should only be based on the results of compliance tests.

Depth Tests

Depth tests involve examination of representative transactions from their initiation through their final inclusion in the financial statements. This examination includes the inspection of the various documents and records created at each stage through which a transaction progresses and the inspection of evidence concerning the existence and application of internal control procedures. In other words, depth testing involves tracing representative transactions through the various stages from beginning to end, examining at each stage to an appropriate extent the vouchers, records, documents and authorities relating to that stage and observing the incidence of internal check and delegated authority. For example, verification of payment to a creditor for goods supplied could be made by an examination of the counterfoil of the cheque which had been drawn in favour of the creditor. In depth verification of this transaction involves its examination at different stages including the following documents and records:

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(a) properly authorised requisition, pre numbered;

(b) copy of the original order, pre numbered and properly authorised, placed with approved suppliers;

(c) the invoice and the statement from the supplier;

(d) entries in the Purchase Day Book;

(e) posting to Purchase Ledger and Purchase Ledger Control Account;

(f) counterfoil of the cheque paid in settlement;

(g) entry in the cash book;

(h) posting from the cash book to Purchase Ledger and Purchase Ledger Control Account;

(i) entry in bank pass book/bank statement;

(j) Goods Received Note and inspection certificate to ensure compliance with the order regarding specification, quantity, quality, etc.;

(k) evidence that the goods have been recorded in the stock records.

It is not necessary that the above procedures should be followed in the sequence suggested above. The important point to be noted is that from the moment it becomes necessary to place an order for goods, a chain of events is set in motion, together leaving what is termed an AUDIT TRAIL. Every step in the audit trail should be examined carefully. It is also not necessary that the examination should begin with the first in a series of events. As a matter of fact, it is a good practice to trace the stages in a transaction in the reverse order in certain cases. For instance, in the above example the tests may commence from an examination of the evidence that the goods have been entered in the stock records. Then it may be traced back through the various stages to the authorised requisition for goods.

It is usual to reduce progressively the number of transactions selected for examination as the depth of the examination increases, i.e., at each successive stage within the test. For example, it might, in a particular case, be appropriate for the auditor to select two hundred payments to creditors for goods supplied and verify them by examination of the counterfoils of the cheques and the bank pass book/bank statement; only a proportion of these two hundred payments would be verified with the requisitions and copies of the original order; only a proportion of these would be verified with suppliers' invoices and statements; a still smaller proportion would be verified in addition by evidence that goods had been received; and so on until a comparatively small proportion had been verified completely in depth.

Depth tests are used as part of both compliance testing and substantive testing. As part of compliance testing these are used to obtain evidence that the internal control system stated to be in operation is being followed in actual practice. For this purpose beginning at the point where a transaction is authorised or consummated, the procedures for creation of documents evidencing the transaction are compared with the procedures stated in the description of the system, and each subsequent operation in the system is similarly reviewed. Evidence of what is actually being done is gained by observing employees in the act of performing their duties, by questioning employees about what they do and how they go about doing it and so on.

It may be noted in this connection that testing in depth occupies a very important place in contemporary audit practice and more often they are carried out to achieve the purpose of both compliance testing and substantive testing concurrently.

Corroborative Tests

This is a term used to mean ‘depth tests’ used as a part of compliance testing.

Weakness Tests

These are additional tests which become necessary in the light of the number of breakdowns in internal controls or other weaknesses brought to the attention of the auditor.

Rotational Tests

The term “rotational tests” is used generally to imply either of the following two basic procedures:

(i) Additional tests in one selected area of the client business: In addition to the routine tests planned in the audit programme, it is common for the auditor to select any particular area of the client business for a thorough detailed examination. For instance, the auditor, during a particular year, may decide to check in detail the working of the wages department by carrying out tests additional to those routine tests planned in the audit programme. During the next year, another area (or, even the same area) will be selected for such detailed examination. Thus over a period of years all the important areas will have come under the auditor’s detailed examination. The area to be subjected to such detailed examination should be selected at random so that the whole organisation is kept alert all the time because of the uncertainty as to which area the auditor will select for this purpose.

(ii) Visits to a sample of locations in each year on a rotational basis: Where the client has several significant places of business (branches, warehouses, etc.) it is likely that the auditor will find it impracticable to visit each place of business every year to verify the procedures there. In such a situation it is a normal practice for the auditor to arrange visits to a sample of locations each year in such a way that over a period of years all material locations will have been visited by him. For reasons noted in (i) above, selection of sample of locations should be done on a random basis.

Substantive Tests

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Substantive tests are defined as those tests of transactions and balances, and other procedures such as analytical review, which seek to provide evidence as to the completeness, accuracy and validity of information in the accounting records or in the financial statements. According to International Auditing Guidelines, substantive procedures are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system. They are of two types, viz., (i) tests of details of transactions and (ii) analysis of significant ratios including the resulting investigation of unusual fluctuations and items. In other words, substantive testing includes vouching tests on transactions, verification tests on balances and analytical review procedures.

Check Your Progress

3. State the object of conducting walk-through tests.
4. What do depth tests involve?
5. What are the types of substantive tests?

4.4 AUDIT SAMPLING AND TEST CHECKING

It may be appreciated that a hundred per cent check of all the items included in the accounts is not a practical proposition because of the high cost of auditing and the gigantic size of modern business establishments. As a result, under modern conditions the idea of test check is introduced, and only a proportion of each class of items is examined by the auditor. Of course, in some cases, a hundred per cent check is still necessary. For instance in the following cases the auditor has to resort to such hundred per cent check:

(i) Items which are few in number but of considerable importance in relation to the accounts, e.g., land and buildings.

(ii) Items with special importance in which case the concept of materiality is the prime consideration, e.g. directors' remuneration.

(iii) Exceptional and extraordinary items.

(iv) Areas where the auditor's suspicion is aroused and put on enquiry.

4.4.1 Test Checking and Its Limitations

As mentioned earlier, it is not always possible nor a statutory requirement for companies to check the entire accounting books of the company. This is because the process is not only very lengthy but also cumbersome. Test checking refers to the concept of select verification of particular accounts and entries of the books of a company. This method can be used by auditors in cases where the auditor is of the opinion that appropriate internal control system is being followed by the company. It would not be wrong to say that the results through this method is not hundred percent reliable but does offer a considerably degree of reliability. Generally, entries of large amounts and critical matters are checked thoroughly while balance entries are checked randomly.

Certain points should be kept in mind while employing test checking:

- There should not be any bias in the selected transactions
- The auditor should use his experience to determine the number of transactions that need to be checked
- If any frauds or errors are detected during test checks, these must be investigated thoroughly
- Classification of transactions may be done by grouping similar transactions
- The extent of test check should be based on the level at which the internal control system is functioning in the organization

Test checking saves time saves labour and costs. It also ensures that the accounting staff is alert and careful since random checking may be done. But it suffers from certain limitations as well

Limitations of Test Checking

- It levies an increased level of responsibility on the auditor since he will be accountable in case errors or frauds go undetected and revealed later.
- It is not a suitable method of auditing for organizations which are small-scale.
- There may be chances that the accounting staff becomes less diligent with their work since not all accounts are going to be checked in detail.
- Companies may find it easier to hide planned frauds from the accounts since not all accounts are checked.

4.4.2 Judgement and Statistical Sampling

As observed earlier, in most cases, the auditor resorts to test checks. In adopting this procedure, the auditor faces mainly two problems. First, he has to decide as to how many items out of the total he should check. Second, which are the specific items to be checked. In solving these two problems sampling techniques are adopted. These sampling techniques are mainly (a) judgement sampling, and (b) statistical sampling. In both these techniques, from an examination of a particular category of items, conclusions are drawn about a large group of data, e.g. all the entries in the purchase day book.

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Judgement Sampling

This is non-statistical sampling. Here the auditor selects the sample using his judgement to take account of factors such as materiality, known areas of weaknesses or risks discovered during the course of, or before, the audit (e.g. detection of frauds during previous audits, insufficient documentation in certain areas, specific matters arising from internal audit reports, etc.). In other words, the auditor is using his skill and experience on a particular area from which he is choosing the sample, in order to select the sample. Normally a judgement sample would consist of all items over a certain value in addition to a further number chosen in a haphazard manner. This technique has the advantage in that the auditor can bring his judgement and expertise into play. Further, it does not require any special knowledge of statistics. But the fact has to be admitted that a judgement sample is not objective because of the possibilities of the auditor's personal bias entering into the selection of the sample. Items in the category which may be too inconvenient to obtain or which may cause extensive work may be left out of a sample. In other words, there is always the possibility for the auditor to give undue preference to items which are comparatively easy to obtain and are likely to be correct. A judgement sample is unscientific because there is no logical or mathematical justification in projecting the qualities possessed by the sample on to the whole population. Another disadvantage of this sampling technique is that there is always the possibility of sample size being too large and, to that extent it is wasteful. Additionally, when using non-statistical sampling it is not possible to make any quantifiable statement about the area examined. A statistical approach will have to be adopted when such a statement is required.

Statistical Sampling

Statistical sampling technique is no doubt more scientific than judgement sampling in that, for audit purposes, it involves the application of the mathematical laws of probability to that area of audit testing, designed to discover the reliability of the client's underlying records, as a basis for the preparation of financial statements. It is well known that any form of sampling rests on the statistical principle that, the objective examination of an unbiased selection of items from a large population, will enable the examiner to draw mathematically valid conclusions about the population as a whole, from the items included in the sample. Statistical sampling is particularly useful where the areas of account contain a large number of transactions of similar size, or for overall substantive testing. This, however, does not mean that the auditor should have extensive knowledge of statistics in order to apply statistical sampling in the execution of audit programmes. Statistical tables are available which indicate sample size, based on predetermined criteria.

Aims of Using Statistical Sampling Technique

An auditor making use of statistical sampling technique aims to achieve the following:

(a) Make such tests of the transactions carried out during the particular accounting period as will enable the auditor to assess the soundness of the internal control system, and the extent to which the accounting system and the related internal controls have complied with the system.

(b) Carry out such physical and direct tests by way of verification of the assets of the business as will enable the auditor to satisfy himself as to their existence and as to the correctness of the detailed records of such assets.

(c) In case a complete physical examination of any particular asset would cause undue disruption to the client's business, allow the auditor to carry out a meaningful test without causing disruption.

(d) Carry out tests with the minimum number of audit staff.

(e) Employing sample sizes with a sound scientific basis, carry out audit tests, providing the auditor with an assurance that the sample is representative of the whole population being examined.

Problems of Using Statistical Sampling Technique

It should be clearly understood in this connection that the use of statistical sampling does not relieve the auditor of his responsibility to exercise proper care and skill in testing the records of the business. Hence before making use of statistical sampling technique, it is necessary for the auditor to consider carefully various problems likely to arise in the selection of the sample.

(i) The size of the population: "Population" in this context refers to the entire set of data about which the auditor would wish to reach a conclusion. Sampling units are those individual units that make up the population. The auditor should ensure that the population to be sampled is free from any bias. For instance, where a test is planned of physical stock, the section of items carrying high value should be segregated from the rest of the population being tested and should be the subject of a separate check. Again, the auditor should make sure that the population from which he draws the sample is appropriate for the specific audit objective. For instance, if the objective of the auditor is to test for overstatement of accounts receivable, then the 'population' is the accounts receivable trial balance. On the other hand, where the auditor's objective is to test for overstatement of accounts payable, his 'population' would not be accounts payable trial balance but could be subsequent disbursements, invoices not paid or receiving reports which are not matched. Still another example could be found in purchase invoices. Where the audit objective is to find out whether all the purchase invoices have been entered in the purchase day book, then the 'population' is all the purchase invoices. Suppose the system of recording the purchase invoices

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has been changed during the middle of the accounting period. In that case, two separate 'populations' will have to be taken - one, before the change and the other, after the change.

(ii) ***Determination of the sampling method:*** Depending on the circumstances, the following methods are suitable:

(a) **Random sampling:** In random sampling all items in a population have a mathematically calculable chance of being selected in the sample. The auditor takes the numbers to be selected from the random number tables, which are constructed to identify the items to be examined in a random test. Here a prerequisite is that the items in the population should be numbered sequentially. Random selection ensures that all items in the population have a known chance of selection, and that, there is no bias in the selection of items. Thus, the results obtained in the sample can be projected onto the whole population from which the sample was taken, with degrees of reliability which can be calculated in mathematical terms. In other words, the auditor can use random samples to make conclusions about the area under examination with degrees of reliability which can be justified statistically. This is a form of audit evidence which enables the auditor to make conclusions about levels of materiality and reliability, which will be of immense value in forming an opinion on the client business in general and the accounts in particular. While making use of random sampling, the auditor may determine acceptable levels of error rate before beginning his work. In this manner it is possible for the auditor to reduce the number of items selected for examination in the sample with the resultant reduction in the time spent and the cost of audit examination.

(b) **Acceptance sampling:** In the case of acceptance sampling, the auditor selects a random sample from a 'population'. If he does not find a predetermined number of errors, the population from which the sample was drawn is considered to be satisfactory. For example, this technique would be found suitable for use when an auditor is examining work in progress in a factory, where it is accepted that a given proportion of items in work-in progress will prove to be defective. This proportion would be allowed for in calculating the value of work in progress for accounting purposes. In the test, if the auditor finds the number of defective items below the given level, the conclusion will be applied to the whole 'population'.

(c) **Interval sampling or systematic sampling:** In this case the auditor selects a random starting point. After that, he makes selections of items in such a way that there is a fixed interval between the items selected. The interval may be based on a certain number of items or on monetary totals (e.g. every Rs.5,000 in the cumulative value of the population). Where the interval is based on a certain number of items,

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and, where the size of the sample requires that every fiftieth item needs to be selected, the auditor selects 38 as the random starting point, the test thereafter would be on the 88th, 138th and so on. When making use of this technique, the auditor should make sure that the population is not structured in such a way that the interval corresponds with a particular pattern of the 'population', e.g. every fiftieth item relates to a particular branch.

(d) **Discovery sampling:** Here the object of the auditor is not to determine a percentage of 'population'. Instead he tries to ensure that no items possess certain qualities. For instance, the auditor wants to test that effective internal control is in operation in the Accounts Payable Section in a business enterprise. He may want to make sure that before each invoice is paid, it is matched with an authorised Goods Received Note. Even if one invoice in the test is not matched with the Goods Received Note, it will be an indication that the internal control system is not operating properly and as such the system cannot be relied upon.

(e) **Cluster sampling:** Where the data to be tested are stored in such a way that the selection of a group or cluster would be an appropriate test. For instance, where the data to be tested are stored in filing cabinet drawers, each drawer could be given a number and the particular drawer to be examined could be selected with the help of random tables. The data contained in the drawer selected could be tested completely or by random number sampling or interval sampling.

(f) **Stratified sampling:** Here the population is divided into layers or strata and each layer or stratum is examined separately with the help of interval sampling technique or random sampling technique. This is especially suitable where the 'population' consists of a wide range of values among the items under examination. Then the whole 'population' could be divided into a number of layers, each layer comprising a specific range of values or prices. A separate test is conducted for each layer.

(g) **Estimation sampling:** This is the most commonly used sampling technique. In estimation sampling, the sample is used to estimate the proportion of a 'population' possessing certain characteristics. Estimation sampling could be either Attribute Sampling or Variables Sampling. In attribute sampling, the auditor tries to find out the number of items of a certain type in a 'population'. In variables sampling, the auditor tries to find out the average value of the items with certain characteristics. For instance, where an auditor wants to find out how many debtors are overdue in settling their accounts, attribute sampling could be used. Where the auditor wants to estimate the total value of debtors who have not settled their accounts within the normal period of credit, variables sampling could be used.

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(iii) ***The level of confidence required by the auditor:*** This means that the auditor would have to determine the degree of certainty that the whole population would be covered by the test to be undertaken. The level of confidence selected will be based on the auditor's past experience of the particular test being undertaken and his assessment of internal control surrounding that area.

(iv) ***Examination of the 'Attribute':*** 'Attribute' in this context refers to the quality possessed or not possessed by each item. For example, the auditor would test the attribute 'correctly entered'. What the auditor wants to know here is the error rate.

(v) ***Required precision limits:*** Although it is not possible to determine exactly the error rate in a 'population' through sampling, a range within which error rate lies could be found out.

Based on (iv) and (v) above, the percentage of errors which the auditor is prepared to accept should be predetermined. This should be on the basis of the materiality of the test in relation to the accounts as a whole, and on the effectiveness of the internal control system concerning the particular procedure. Usually the auditor allows a slight variation on the percentage of errors allowable. Where the percentage is exceeded, further checking is usually required, until the auditor is in a position to reach a firm conclusion on the accuracy or otherwise of the items being tested.

In conclusion, it may be observed that there is a difference in the position of an auditor and others who make use of sampling techniques in interpreting their results. For instance, a scientist may only have the results of his sampling to guide him, and his conclusions must stand or fall on the results of the test. An auditor's position is different. The results from a sample survey is only one among various sources of information an auditor has about the accounts of his client. In other words, the result of a sample test is only one piece of evidence on which the auditor bases his conclusions. Assessment of the system of internal control, discussions with the management, the results of other tests carried out by the auditor, etc. are other pieces of evidence he obtains. The auditor usually considers the combined assurance from all audit procedures and the estimated error (both projected from the sampling procedures and known errors from non-sampling procedures) in determining whether he has obtained sufficient, appropriate audit evidence.

Evaluation of Sample Results

Examination of the errors detected is the most important stage in the evaluation of sample results. In examining the errors detected, the following points should be considered:

(i) Whether any of the errors would materially affect the figures in the accounts.

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(ii) Where any error is material, whether it could be corrected. If so, the same should be done.

(iii) Where any error is material and cannot be corrected, the need for a qualified opinion should be considered.

(iv) Even where an error is not material, the same should be documented and considered later along with any other errors which are also not material individually, so that a decision could be made as to whether taken together they are material.

(v) The qualitative aspects of the errors are also important. These include the nature of the errors, the reasons for the errors, the possible impact of the errors on other phases of the audit (e.g. the extent of planned reliance on internal control procedures), etc.

(vi) Where the errors detected indicate a common feature (e.g. type of transactions, location, period of time, product line, etc), it would be advisable to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. Based on the items examined for each sub-population, the auditor should perform separate evaluations.

(vii) Where errors in the 'population' exceed the tolerable error rate and the auditor determines that the risk is not acceptable, he should consider extending the audit procedures, or performing alternate audit procedures.

(viii) In compliance procedures, where the evaluation of errors indicates to the auditor that the sample results do not support his planned degree of reliance on a control procedure, he may ascertain whether there is any other appropriate control on which reliance may be placed by applying appropriate compliance procedures. Alternatively, he may modify the nature, timing and extent of his substantive procedures.

(ix) Finally, it is important for the documentation of all the errors detected, together with proposals for action so that seniors can consider the significance of errors in relation to the final accounts. Where a large number of errors is detected, seniors should immediately be contacted to decide upon how they should be dealt with. It may be possible that the errors detected indicate the existence of other errors which could lead to a qualified opinion.

Check Your Progress

6. State the problems an auditor faces in adopting the test check procedure.
7. Why is judgement sampling called unscientific?
8. In which type of sampling does the auditor tries to ensure that no items possess certain qualities?

4.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

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1. While obtaining audit evidence through the performance of compliance procedures, the following assertions should be given importance: existence, effectiveness and continuity.
2. Certificates from third parties may be broadly grouped under two categories, viz., (i) certificates as verification of assets held by third parties on behalf of the client organization and (ii) certificates as verification of amounts due by the client organization to the third parties.
3. The object of walk-through tests is to confirm that there is no reason to suppose that the accounting system and related internal controls do not operate in the manner they were recorded.
4. Depth testing involves tracing representative transactions through the various stages from beginning to end, examining at each stage to an appropriate extent the vouchers, records, documents and authorities relating to that stage and observing the incidence of internal check and delegated authority.
5. Substantive tests are of two types, viz., (i) tests of details of transaction and (ii) analysis of significant ratios including the resulting investigation of unusual fluctuations and items.
6. In adopting the test check procedures, the auditor faces mainly two problems. First, he has to decided as to how many items out of the total he should check and second, which are the specific items to be checked.
7. Judgement sampling is called unscientific because there is no logical or mathematical justification in projecting the qualities possessed by the sample on to the whole population.
8. Discovery sampling is the type of sampling where the auditor tries to ensure that no items possess certain qualities.

4.6 SUMMARY

- The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as: auditor's knowledge of business and industry; degrees of risk of misstatement, matrilocality of item in relation to the financial statements; experience gained during previous audits; extent of irregularities revealed and material variances, etc.
- While obtaining audit evidence through the performance of compliance procedures, the following assertions should be given importance: existence, effectiveness and continuity.
- While obtaining audit evidence through the performance of substantive procedures, the following assertions should be given importance: existence,

rights and obligations, occurrence, completeness, valuation and accuracy, measurement and presentation and disclosure.

- The auditor should be thorough in his efforts to obtain evidence and should be objective in its evaluation. In selecting procedures to obtain evidence, he should recognise the possibility that the financial statements may be materially misstated.
- As in all audit procedures, the cost of obtaining audit evidence should bear a rational relationship with the potential benefits or the usefulness of the information received.
- The reliability of audit evidence is influenced by its source (internal or external) and by its nature (visual, documentary or oral). In other words, the reliability of audit evidence in forming an opinion on the relevant financial statements depends on the circumstances under which such evidence is obtained.
- Corroborative evidence obtained from third parties outside the client organisation is usually considered to be reliable audit evidence. Hence it is a normal audit procedure to obtain certificates from third parties as verification of items included in the financial statements.
- Audit evidence is obtained through one or more of the following techniques of audit testing: inspection, observation, enquiry and confirmation, computation and analytical review.
- Audit procedures should be based primarily on an appropriate series of tests designed to satisfy the auditor that the internal control system is properly operating and is effective so that the records can be regarded as a reliable basis for the preparation of the financial statements.
- The tests include compliance test, walk-through tests, depth tests, corroborative tests, weakness tests, rotational tests, and substantive tests.
- It may be appreciated that a hundred per cent check of all the items included in the accounts is not a practical proposition because of the high cost of auditing and the gigantic size of modern business establishments.
- In test checking procedure, the sampling techniques are used by auditors. These include judgement sampling and statistical sampling.

4.7 KEY WORDS

- **Audit tests:** These are tests designed to satisfy the auditor that the internal control system is properly operating and is effective so that the records can be regarded as a reliable basis for the preparation of financial statements.
- **Judgement sampling:** It refers to non-statistical sampling technique in which the auditor selects the sample using his judgement to take account of factors such as materiality, known areas of weaknesses or risk discovered during the course of, or before, the audit.

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- **Statistical sampling:** It is a technique which involves the application of the mathematical laws of probability to that area of audit testing, designed to discover the reliability of the client's underlying records, as a basis for the preparation of financial statements.

4.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the factors which affect what constitutes sufficient appropriate audit evidence?
2. Write a short note on circumstantial evidence as a form of audit evidence.
3. How are depth tests used as part of both compliance testing and substantive testing?
4. List the cases in which the auditor has to resort to hundred per cent of all the items included in the accounts.
5. Write a short note on judgement sampling.
6. State the aims of using statistical sampling technique.

Long Answer Questions

1. Examine the factors to be considered in obtaining audit evidence.
2. Explain the general presumptions which are useful in assessing the reliability of audit evidence.
3. Discuss the principles which should be complied by certificates obtained from third parties for them to be considered as valid audit evidence.
4. Describe the different types of audit tests.
5. Explain the problems of using statistical sampling technique.
6. What are the points that should be considered while examining the errors detected in sample results?

4.9 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

Shekhar, L and K C Shekhar. 2003. *Auditing, 20th edition*. Delhi: Vikas Publishing House.

Prakash, Jagdish. 2014. *Auditing: Principles, Practices and Problems*. New Delhi: Kalyani Publishers.

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BLOCK II
AUDIT OF LEDGER VERIFICATION AND COMPANY AUDIT

UNIT 5 AUDIT OF LEDGERS AND FINANCIAL OR SPECULATIVE DERIVATIVES

Structure

5.0 Introduction
5.1 Objectives
5.2 Audit of Ledgers and Tthe Role of Auditor
5.3 Auditing of Financial and Speculative Derivatives
  5.3.1 Price Risk Derivatives, Foreign Exchange Instruments and their Audit
5.4 Answers to Check Your Progress Questions
5.5 Summary
5.6 Key Words
5.7 Self Assessment Questions and Exercises
5.8 Further Readings

5.0 INTRODUCTION

Now that you have learnt the basics of auditing process including the processes of internal control and collection of audit evidence. In this unit, we move towards special types of audits conducted for companies. The role of the auditor is extremely crucial to not only verify the appropriate entry and posting of transactions but also ensure that sound principles and practices are being followed when it comes to risk measurement and assessment in highly volatile instruments like derivatives and price risk and exchange commodities. In this unit, you will learn about the audit of ledgers, financial and speculative derivatives and price risk and exchange.

5.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the audit of ledgers and role of auditors
- Describe the audit of financial and speculative derivatives
- Explain the audit of price risk and foreign exchange instruments

5.2 AUDIT OF LEDGERS AND THE ROLE OF AUDITOR

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Companies maintain many different types of ledgers as a record of their transactions. Entries recorded in the cash book, sales book, purchase book, sales return books and purchase return books are all posted to the ledgers. Therefore, while auditing it is important that the auditors check and verify entries made in the main journal, the general ledger along with other personal ledgers like sales and purchases ledgers.

For auditing main journal, the opening, closing, transfer, rectification, adjustment and entries related to the share capitals must be scrutinized carefully. Evidences used for such could include minutes of meetings, meetings of shareholders, correspondence copies and other sources in business with the company. For auditing general ledger, all the subsidiary books should be checked properly for adherence to the accurate accounting standards. The total balance of specific ledgers should be tallied with the total of the general ledgers.

While auditing purchase ledgers the following points should be kept in mind:

- Use the audited balance sheet of previous year to verify the opening balance
- Check the schedule of creditors
- Tally the closing balance of different creditors with the closing balance of the purchase ledger
- Verify the totals of general ledger and closing balance of purchase ledger
- Statement of accounts should be tallied with the closing balance
- Non-payment of purchases which drag to longer periods should be scrutinized and the reason for delay checked
- Check for fictitious credit entries
- Check reasons for debit balances if any on account of discounts, advanced, amount due on goods return etc.
- Ensure that disputed amounts are appropriately shown as contingent liability

While auditing sales ledger, the following points should be considered:

- Verify the opening balance through last year's audited balance sheet
- Analyse the amounts that are written off as bad debts and the reasons for them
- Check for reasons on amounts mentioned as dispute with customers and their proper entry
- Check whether transfer of entries from one ledger to another is verified.
- Confirm balances directly with debtors for higher authenticity
- Check for fictitious discounts or allowances and the reasonings for cash discounts if provided

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- Ensure that the part payments of outstanding amounts are posted in an appropriate order
- Check whether disclosures by directors or managers in interest companies are listed out
- Check whether provision for doubtful debt is made
- Tally closing balance of debtors with the balance of sales ledger

5.3 AUDITING OF FINANCIAL AND SPECULATIVE DERIVATIVES

Different derivative instruments are used for business in India. The main regulatory bodies for these derivatives include the RBI, SEBI and the Forwards Markets Commission.

The Reserve Bank of India Act defines derivative as 'An instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time.'

In India, SEBI has been given the responsibility of managing policies and frameworks related to the derivatives. In general, a framework governing derivatives and covering risks must include the following points:

- Mention and define the different authorized derivative products and activities
- Detail the requirements for approval and authorization of new derivative products and activities
- Mention the institution's capability and capacity for taking risk and managing derivatives in tune with its stated objectives, skills of its management, availability of capital, etc.
- Ensure that efficient and appropriate staffing is done so that the approved derivative activities are carried in a competent manner.
- Delegate and establish managerial responsibilities and key control functions.
- Establish a system of risk assessment and measurement which are suitable for the derivative activities to be undertaken.
- Make the assessment of potential risks that may be faced by the bank and the methods of controlling and combating it.
- Conduct stress testing of high-risk areas
- Establish a proper system of reporting which specifies the types and frequency of reports that need to be submitted to the board.

In general, such frameworks should cover areas of compliance, levels of risks undertaken, financial performance, procedures followed, etc.

Internal Audit

The following points should be kept in mind which conducting internal audit for the financial and speculative derivatives:

- Check the effectiveness of compliance policies
- Test the adequacy of operational controls and staff compliance
- Review the reporting of information to the board of directors and its effectiveness
- Check for unusual, unauthorised and fraudulent trades and valuations
- Review the efficacy of risk exposure reports
- Test the workings of the risk management process and its functioning and effectiveness
- Verify and validate the models being used for risk measurement
- Check the compliance of risk disclosure statements given to the customers with suitable policies
- Appropriateness of accounting methods as well as valuation of derivatives should be checked by independent parties.

The internal audit report should clearly highlight the areas of weakness in controlling operations and provide a suitable action plan to be implemented by the management in an appropriate time frame.

5.3.1 Price Risk Derivatives, Foreign Exchange Instruments and their Audit

The changes in the valuation of financial portfolios leads to changes in the earnings. This risk to earnings or capital which are affected by the change in valuation of portfolios are called price risk. Dealing and position taking activities in different financial markets including foreign exchange, commodity or interest rate markets lead to price risks.

The degree of price risk is directly proportional to two factors: price sensitivity of the instrument and the time it takes to liquidate the position.

The complexity and extent of activities of financial derivates have direct nearing on the type and role of risk control function that needs to be functioning in an organization. It is generally seen that the risk assessment of derivatives is far more difficult and critical when compared to the conventional products and this is why the risk control function becomes the most significant for the board and senior members. Audits in such cases do not replace the risk control function but actually acts like a complementary element to it.

There are also risks associated with the movements of foreign exchange financial instruments. These risks are also termed translation risks. These risks could be a result of holding accrual accounts of dominant foreign currency, exchange of structured notes, off-balance sheet derivates, synthetic investments among others. Periodic evaluation at the then current exchange rate is crucial to the correct management of risks arising from foreign exchange financial instruments.

Audits of price risk derivatives and foreign exchange financial instruments should ideally be done by non-interested and independent qualified professionals. The scope will depend on the volume as well as risk involved in the activities.

The following points should be kept in mind while auditing price risk derivatives and foreign exchange financial instruments:

- Check compliance with the policies and limits set by the banks
- Check the functioning of the internal control system in terms of its operations and effectiveness.
- Verify the sources used for making risk exposure reports
- Check the appropriateness of time and the reliability of the reports submitted to the higher management
- Verify the independence of the risk assessment processes in operations
- Validate the models used for basing risk measurements
- Check the compliance with accounting policies

Check Your Progress

1. What are the entries which must be carefully scrutinized while auditing main journal?
2. List the evidence which could be used for auditing of main journal.
3. What areas should be covered by frameworks governing financial or speculative derivatives?
4. Mention the points which must be highlighted by internal audit report in case of financial or speculative derivatives.

5.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. For auditing main journal, the opening, closing, transfer, rectification, adjustment and entries related to the share capitals must be scrutinized carefully.

2. Evidences used for such could include minutes of meetings, meetings of shareholders, correspondence copies and other sources in business with the company.
3. Frameworks governing financial or speculative reports should cover areas of compliance, levels of risks undertaken, financial performance, procedures followed, etc.
4. The internal audit report in case of financial or speculative derivatives should clearly highlight the areas of weakness in controlling operations and provide a suitable action plan to be implemented by the management in an appropriate time frame.

5.5 SUMMARY

- Companies maintain many different types of ledgers as a record of their transactions. Entries recorded in the cash book, sales book, purchase book, sales return books and purchase return books are all posted to the ledgers. Therefore, while auditing it is important that the auditors check and verify entries made in the main journal, the general ledger along with other personal ledgers like sales and purchases ledgers.
- For auditing main journal, the opening, closing, transfer, rectification, adjustment and entries related to the share capitals must be scrutinized carefully.
- For auditing general ledger, all the subsidiary books should be checked properly for adherence to the accurate accounting standards.
- Different derivative instruments are used for business in India. The main regulatory bodies for these derivatives include the RBI, SEBI and the Forwards Markets Commission.
- In general, a framework governing derivatives and covering risks must cover areas of compliance, levels of risks undertaken, financial performance, procedures followed, etc.
- The internal audit report should clearly highlight the areas of weakness in controlling operations and provide a suitable action plan to be implemented by the management in an appropriate time frame.
- The changes in the valuation of financial portfolios leads to changes in the earnings. This risk to earnings or capital which are affected by the change in valuation of portfolios are called price risk. Dealing and position taking activities in different financial markets including foreign exchange, commodity or interest rate markets lead to price risks.
- The degree of price risk is directly proportional to two factors: price sensitivity of the instrument and the time it takes to liquidate the position.

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- There are also risks associated with the movements of foreign exchange financial instruments. These risks are also termed translation risks. These risks could be a result of holding accrual accounts of dominant foreign currency, exchange of structured notes, off-balance sheet derivates, synthetic investments among others. Periodic evaluation at the then current exchange rate is crucial to the correct management of risks arising from foreign exchange financial instruments.
- Audits of price risk derivatives and foreign exchange financial instruments should ideally be done by non-interested and independent qualified professionals. The scope will depend on the volume as well as risk involved in the activities.

5.6 KEY WORDS

- **Ledger:** It refers to the accounting book in which the entries are classified and recorded on the basis of original entries in the journal.
- **Derivatives:** These are defined as contracts which derive value from prices or index of prices of underlying securities.
- **Foreign exchange risk:** It refers to risk arising out of the fluctuations in value of assets, liabilities, income or expenditure when unanticipated changes in exchange rates occur.

5.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the books to be checked by auditors while auditing ledgers?
2. Mention the factors which affect the degree of price risk.
3. How does the RBI act define derivatives?
4. What are the regulatory bodies governing financial derivatives in India?

Long Answer Questions

1. Explain the auditing of ledgers.
2. Discuss the auditing of financial derivatives, price risk and exchange rate instruments.

NOTES

5.8 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

Shekhar, L and K C Shekhar. 2003. *Auditing, 20th edition*. Delhi: Vikas Publishing House.

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UNIT 6 VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES

Structure

6.0 Introduction
6.1 Objectives
6.2 Auditor's Position Regarding the Valuation and Verifications of Assets and Liabilities
  6.2.1 Valuation and Verification of Assets
  6.2.2 Valuation and Verification of Liabilities
6.3 Depreciation and Auditor's Position
6.4 Reserves, Provisions and Secret Reserves and Auditor's Position
6.5 Answers to Check Your Progress Questions
6.6 Summary
6.7 Key Words
6.8 Self Assessment Questions and Exercises
6.9 Further Readings

6.0 INTRODUCTION

In this unit, you will study the verification and valuation of assets and liabilities. Assets and liabilities are important components of a company's balance sheet. Valuation and verification of these is essential to obtain an accurate picture of a company's financial status and health. The unit defines assets and liabilities and outlines the general principles related to these. It then differentiates between the verification and valuation of fixed assets. Current assets, verification of liabilities, etc., are also discussed.

Businesses own a number of assets like machinery, buildings, vehicles, etc, which undergo depreciation. Depreciation is an important factor in accounting and audit.

In this unit, we will study the concept of depreciation and auditor's role in the assessment of depreciation. Finally, you will also learn about the concepts of reserves and provisions and auditor's responsibility toward reporting of such items.

6.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the meaning of assets and liabilities
- Describe the valuation and verification of different assets and liabilities

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- Explain the concept and assessment of depreciation
- Examine auditor's role in verification of depreciation
- Discuss the concept of reserves, provisions, and secret reserves
- Explain auditor's duties with regards to reserves and provisions

6.2 AUDITOR'S POSITION REGARDING THE VALUATION AND VERIFICATIONS OF ASSETS AND LIABILITIES

Before we study the various aspects of assets and liabilities, let us understand the meaning of these terms. The term 'asset' refers to a resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide future benefit. Assets can be of two types – fixed and current.

Fixed assets: Fixed assets are those that are acquired by a business for the purpose of use in the business with the object of earning revenue and which are not intended for resale at a profit and conversion into cash in the ordinary course of business. They may broadly be classified into tangible and intangible assets. Tangible assets are those which have definite shape and which can be seen, e.g., plant and machinery, motor vehicles, land and buildings, furniture and fittings, investment property, etc. Intangible fixed assets are those that are not perceptible by touch; but nevertheless employed in the business for earning revenue, e.g., patents, copyrights, trademarks, goodwill, deferred expenditure such as development costs and franchises, etc.

Current assets: Current assets refer to a balance sheet account that represents the value of all assets that are reasonably expected to be converted into cash within one year in the normal course of business. Current assets include cash, accounts receivable, inventory, marketable securities, prepaid expenses and other liquid assets that can be readily converted to cash (investopedia.com).

6.2.1 Valuation and Verification of Assets

Valuation of assets: Valuation is a method of assessing the worth of a company, real property, security, antique or other item of worth. It is commonly performed prior to the sale of an asset or prior to purchasing insurance for an asset.

Verification of assets: Verification refers to the process conducted by auditors to confirm that a company's assets actually exist. This may be performed by one to several auditors that will take a company's books and confirm that each asset listed is accounted for. Some of these auditors may be specialists on the auditing of a specific type of asset, which helps prevent an auditor from having to account for assets that he/she does not know exactly how to verify. An auditor may examine financial records, contracts, and other policies to verify any asset that is not physically at the company (investorwords.com).

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Difference between Verification and Valuation

- Verification is carried out in order to prove the existence, ownership and title to assets whereas in the case of valuation it certifies the value as at the date of the balance sheet.
- Verification is carried out for both assets and liabilities whereas in the case of valuation only the values of assets are certified.
- Auditor does the work of verification. Valuation is done by appropriate experts and responsible officials.
- Evidence is the basis of verification. Certificates issued by the officials form the basis of valuation.

Auditor's Position as Regards Valuation of Assets

At the very outset, it may be noted that an auditor is not a valuer and he/she cannot be expected to act as such. Valuations are made by appropriate experts or responsible officials of the entity who have practical knowledge of the items concerned. The auditor's duty is to test whether the valuation is fair and reasonable and that it is in accordance with accepted principles. As observed in the Kingston Cotton Mill company Case, an auditor is not guilty of negligence if he/she accepts the certificate of a responsible official in the absence of suspicious circumstances. According to the observations:

> "...........It is the duty of the auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with a foregone conclusion that there is something wrong. He is a watch dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite his suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful............"

1. Verification and Valuation of Fixed Assets

As fixed assets are acquired by a business with the object of earning profits and are not held for resale in the ordinary course of business, they are valued on the going concern basis. In other words, fixed assets are valued at cost less provision for depreciation or amortization arising from wear and tear, obsolescence, etc. Where there has been a permanent increase in the values of certain fixed assets such as freehold land, the valuation of an expert may be taken into the books of account in place of cost, subject to the provision that any profit arising therefrom is an unrealized profit which is not normally available for distribution.

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Fixed asset register: For the verification of fixed assets, it is essential to maintain an accurate and up-to-date fixed asset register. Large manufacturing companies should invariably maintain a register of their fixed assets in order to control and identify the assets that have been acquired for permanent use in the business. A fixed asset register should contain the following information in respect of each fixed asset.

- date of purchase, with reference to the authority given
- name and address of supplier and cost
- location, brief description and identifying number
- rate of depreciation to be applied
- date of sale, scrapping or transfer, with reference to the authority given and details of amounts received
- dates on which the asset has been physically verified in order to ensure that it is still in use at its specified location
- where any investment grants have been received, details of the same

Fixed asset registers should be maintained for the following reasons:

- It enables the enterprise to have a record of all the fixed assets that it owns.
- It facilitates periodical verification of fixed assets.
- It facilitates the correct computation of depreciation, particularly in case of disposal of assets.
- It assists in ensuring that additions and disposals of fixed assets are properly accounted for in the books of the enterprise.
- It assists in ensuring that there is proper control over fixed assets.
- It enables a check to be made periodically that the rates of depreciation are appropriate. In the case of a limited company there is also the matter of compliance with presentation provisions under the Companies Act.
- It assists in arriving at insurance valuations and insurance claims.

Audit approach in relation to fixed assets: The general audit objectives in connection with fixed assets are:

- **Completeness:** to ensure that all fixed assets owned by the entity at the end of the accounting period have been recorded.
- **Existence:** to ensure that the recorded fixed assets were in existence at the end of the accounting period and remain in use by the entity.
- **Ownership:** to ensure that the recorded fixed assets were properly owned by the entity at the end of the accounting period and that all liens and other encumbrances on them have been properly identified.
- **Valuation:** to ensure that the recorded fixed assets were properly valued at the end of the accounting period in accordance with statutory provisions and generally accepted accounting principles.

- **Disclosure:** to ensure that the disclosure of fixed assets is in accordance with statutory provisions and generally accepted accounting principles.

Goodwill

Goodwill may be defined as the excess of the value of a business as a whole over the fair value of its accountable net identifiable assets, including identifiable intangibles such as trademarks, patents, etc. Where a business is purchased as a going concern, the difference between the purchase price and the net assets acquired indicates the price paid for goodwill. The usual accounting treatment of goodwill is to write off the same over a number of years. The amount so far not written off is shown in the balance sheet. The auditor should review this item for its reasonableness and consistency of amounts between years.

Land and Buildings

In the case of freehold properties, the original title deeds should be examined. It should be ensured that they are free from any mortgage. Strictly speaking, verification of title deeds has to be done by a solicitor. Where the title deeds are deposited with bankers for safe custody, a certificate should be obtained from the bankers that they are held for safe custody and that they are free from any lien, mortgage or other charges.

Where land has been purchased along with building/s, the vendor's sale deed needs to be verified. It must be ensured that the allocation of purchase price as between land and building/s has been made by an appropriate expert unless there is some other sufficient appropriate evidence showing their costs separately. This is important since depreciation is provided on buildings while no depreciation is normally provided on land.

Where the building has been constructed by the client entity, the architect's certificate has to be obtained on the cost and the extent of completion of the building.

Where the building has been constructed by a contractor, the agreement with the contractor regarding the terms of agreement needs to be checked.

In the case of leasehold property, the item needs to be verified by inspecting the original lease. Where the client is not the original lessee, verify the item by inspecting the original lease together with the assignment thereof. If the property is held in the name of a nominee for the client, a letter of acknowledgment therefrom should be obtained. If the lease is acquired during the current accounting period, the cost of the property should be vouched. Where the lease was acquired previously and additions have been made to the property during the current accounting period, the cost of such additions should be vouched by reference to correspondence with solicitors, contractor's accounts, architect's certificate, etc. Provision for depreciation should be on such a basis that the total cost of the lease together with the cost of building/s that may have been erected on the land subsequently is extinguished on the date when the lease is due to expire.

Plant and Machinery

- Check whether the expenses for the erection of plant and machinery are properly capitalized.
- Where the items are purchased on hire purchase or instalment system, examine the relevant agreements. Make sure that the amounts outstanding along with interest and other charges are shown as liability. Check the computation of hire purchase interest and see that the allocation to revenue is correct.
- In the case of motor vehicles, check the registration books and ensure that the client is the registered owner. In the case of new vehicles examine the invoices.
- Examine the insurance policies. Make sure that the premia are up to date.

Patents and Trademarks

Where the client is the owner of a number of trademarks and/or patents, obtain a schedule showing their particulars and verify them with the relevant certificates.

Where a trademark/patent is acquired by assignment, vouch the amount paid by reference to the assignment. Make sure that the same is treated as capital expenditure.

Where a trademark/patent is registered by the client, vouch the amounts treated as capital expenditure (e.g., registration fees) and ensure that the amounts capitalised in respect of staff salaries, overheads, etc (for the time utilised to the design of the trade mark/patent) are easonable.

See that the amounts paid for the renewal of the trade mark/patent are charged to revenue.

Examine the last renewal receipt to ensure that the trade mark/patent has not been allowed to lapse.

See that the trade mark/patent is shown in the balance sheet at cost less depreciation to date.

Investments

Audit of investments has to be carried out very carefully since they represent assets with high inherent audit risk. It may be repeated here that inherent audit risk is derived from the characteristics of the client and the expectation of errors prior to the consideration of the effects of internal controls. It varies according to the accounts item being examined and verified. Investments are one such item and they carry high inherent audit risk as a result of the factors mentioned below.

1. Investments which are in the nature of fixed assets are valued at cost less any permanent fall in value. On the other hand, investments which are in the nature of current assets are valued at cost price or net realizable value

whichever is lower. This, in turn, causes the auditor to refer to some measure of current market value of the investments. The ascertainment of current market value is often complicated and involves the subjective assessment of the client's management (e.g., directors of a company). For instance, valuation of unlisted securities is difficult since there is no established market price. In the case of listed securities, the market value at the date of the financial statements may be ascertained from the Official Lists of recognised stock exchanges. Here also it should be remembered that stock exchanges are often very volatile and that there is a risk that valuation has to be supplemented by post balance sheet events in relation to the movements in the prices of securities concerned.

2. Many investments are readily marketable and thud they could be converted into cash without much difficulty. The point involved in this is that chances of fraud and defalcation are more in the case of such investments. Also, forged investment certificates and investments in fictitious companies are to be guarded against. In short, the auditor is faced with an inherent risk in the audit of investments as a result of greater possibilities of fraudulent activities in relation to this asset.
3. Chances of fraud are more as regards income from investments since they are received at irregular intervals and in irregular amounts. There is a greater possibility that such income may not be posted to the accounting records.

2. Current Assets

Current assets, which otherwise are known as floating assets, are cash and other assets acquired by a business for subsequent conversion into cash, e.g., stock in trade, book debts, bills receivable, etc. The basic principle of valuation of such assets is cost price or market price whichever is lower.

Audit approach in relation to current assets

The general audit objectives in connection with current assets are more or less on the same lines as with fixed assets. In more specific terms, they are as follows:

- **Completeness:** to ensure that all current assets owned by the entity at the end of the accounting period have been recorded.
- **Existence:** to ensure that the recorded current assets were in existence at the end of the accounting period.
- **Ownership:** to ensure that the recorded current assets were properly owned by the entity at the end of the accounting period and all liens, security interests and other encumbrances have been properly identified.
- **Valuation:** to ensure that the recorded current assets were accurately valued at the end of the accounting period in accordance with the entity's accounting policies applied on a consistent basis and generally accepted accounting principles.

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- **Disclosure:** to ensure that the disclosure of current assets is in accordance with generally accepted accounting principles.

Cash in Hand

The internal controls relating to cash should cover the following points:

- Definite rules should be in force as to the size of cash floats to meet expenses and their method of reimbursement.
- Similarly, rules should be in force as to cash floats at cash desks and cash registers.
- Cash floats should be regularly verified by independent officials.
- Procedures should be laid down for the control of funds held in trust for employees, e.g., unclaimed wages.
- Only properly authorized persons should be allowed to have access to cash department and cash registers.

Cash at Bank

The internal control procedures in operation should ensure that there is a proper division of responsibilities between the following:

- officials approving vouchers for payment
- officials having custody of unused cheque books
- officials preparing cheques and recording payments
- officials signing cheques

Sundry Debtors

Internal controls relating to trade debtors are closely associated with internal controls relating to sales. As such they are discussed together in the following paragraphs.

Internal controls relating to sales and trade debtors should be so devised as to ensure that there is proper division of responsibilities between:

- accepting customers orders
- control of credit
- control and dispatch of goods
- processing and recording of invoices
- collection of cash

Proper controls should be in force in the following areas:

- recording and processing of orders
- granting of credit facilities
- goods dispatched
- preparation of invoices

- preparation of credit notes
- recording of invoices and credit notes

Methods of Valuation of Stock in Trade

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Stock in trade (inventories) are generally the second largest item in the financial statements of an enterprise, especially in the case of manufacturing organizations. As such, this item needs extremely careful treatment in that both verification and valuation of inventories assume importance.

Inventories are normally classified in the financial statements under the following heads:

- Raw materials and components
- Work-in-process
- Finished goods
- Stores and spares

Internal Controls Relating to Stock in Trade

It is not possible to lay down any hard and fast rules as to the detailed procedures to be adopted in connection with inventory control or stock control. Such procedures depend on the size of the organization, the quantity and variety of inventories, etc. In general, the following points need attention:

- Proper arrangements should be made for receiving, checking and recording goods inwards.
- A responsible official should undertake the duty of safeguarding inventories.
- Proper precautions should be taken against theft, misuse and deterioration.
- Arrangements should be made for controlling inventories through maximum and minimum stock limits so that materials are readily available whenever required, at the same time ensuring that inventories are not unnecessarily large.
- Proper procedures should be laid down for recording inventories through stock ledgers, independent control accounts and continuous stock records such as bin cards.
- Proper procedures should be laid down for physically checking inventories at periodical intervals and comparing the same with inventory records.
- Arrangements should be made for the periodical review of the condition of inventories and writing off damaged and obsolete items under proper authority.
- Movements of inventories out of store or from one process to another should be properly authorised, evidenced and recorded.

- The arrangements for the issue of inventories should ensure that lots received earlier are automatically issued first.
- Proper arrangements should exist for dealing with and maintaining control over inventories of the business held by others.
- Procedures should be laid down to control and account for waste, and receipts from the disposal of such items.
- Proper cut off procedures should be in operation.
- Custody of inventories should be segregated from control over the records.
- Detailed, clear and foolproof instructions should be issued in connection with annual stocktaking.
- Proper basis should exist for computing the amount at which inventories are to be stated in the accounts. The concept of consistency should be followed in such computation.

Valuation of Inventories, or Stock in Trade

The item 'inventories' is a current asset. The items included in inventories are held for subsequent conversion into cash in the ordinary course of business through sale or for use in the process of production of finished goods or services or for consumption in the production of such finished goods or services. The valuation of inventories is of utmost significance since the value attached to inventories can materially affect the operating results and financial position of an entity. The basic principle of valuation of inventories as pointed out by the Institute of Chartered Accountants of India is cost or net realizable value, whichever is lower. The Accounting Standard AS2 issued by the Institute of Chartered Accountants of India states that this basic principle should be followed in all cases subject to the following exceptions.

- Inventory of consumable stores and maintenance supplies should ordinarily be valued at cost although they may be valued at below cost in appropriate circumstances.
- Inventory of by-products should be valued at cost or net realizable value, whichever is lower. In case it is not possible to ascertain the cost of the by-product, the same should be valued at net realizable value.
- Inventory of reusable waste should be valued at raw material costs less reprocessing cost in case facilities for reprocessing exist.
- Net realizable value should be the basis of valuation in the case of inventory of non-reusable waste or inventory of usable rewaste where facilities for reprocessing do not exist.

The statement further clarifies that special considerations apply in the case of inventories associated with the following:

- plantations, forestry, agricultural commodities and livestock;

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- extractive industries such as mining, quarrying, etc;
- work in progress under long term contracts, such as engineering, real estate development and construction projects;
- securities such as shares, debentures, etc held as stock in trade;
- immovable properties;
- loose tools.

Having stated that the basic principle of valuation of inventories should be cost or net realizable value whichever is lower, it is necessary to explain the meaning of 'cost' and 'net realizable value'.

Methods of Computing Costs

Different methods are used for computing costs. The important among them are as follows:

Unit cost method: Under this method, the total cost is ascertained by aggregating the individual cost of each article, batch, parcel or other unit. The disadvantage of this method is that it is not always applicable, either because the individual units lose their identity (e.g., where inventories are bulked or pass through a number of processes) or because it would involve undue expenses or complexity to keep individual records of cost particularly where these necessitate allocation of expense.

First in, first out (FIFO) method: Under this method, cost is ascertained on the assumption that goods sold or consumed are those which have been longest on hand and those remaining in stock represent the latest purchases or production. The main advantage of this method is that the stock in hand tends to represent a fairly up to date cost.

Average cost method: Under this method, cost is ascertained by averaging the amount at which stock is brought forward at the beginning of a period with the cost of stock acquired during the period, consumption in the period is then deducted at the average cost thus ascertained. The periodical rests for calculating the average will be as frequent as the circumstances and nature of the business require and permit. This method tends to give a lower amount than the cost of unsold stock computed under the 'first in, first out' method during periods of rising price levels. On the other hand, during periods of falling price levels it tends to give a higher amount compared to 'first in, first out' method.

Standard cost method: Under this method, a predetermined or budgeted cost per unit is used. It is particularly useful where items pass through a number of processes or are manufactured on mass production lines; but it will not result in a fair approximation to actual cost unless there is a regular review of the standards with appropriate adjustments and revisions wherever necessary.

Adjusted selling price method (also known as retail inventory method): Under this method, the items are first valued at normal selling prices and then a reduction is made at normal gross profit margins. This method is employed in the retail trade

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where the margins may be largely standardised for large groups of items. The calculation of the estimated gross profit margins may be made for individual items or group of items or by departments, as may be appropriate in the circumstances of each particular case. This method is also employed by some manufacturing organisations for ascertaining the value of finished items held against forward sale contracts. When making use of this method it is important to remember that reductions in selling prices should be reflected while determining stock values as otherwise the items in question will be valued below cost.

Last in, first out (LIFO) method: Under this method, cost is computed on the assumption that stocks consumed or sold are from the latest production or purchases and those remaining in stock represent the earliest production or purchase. This method is criticised mainly on two grounds, viz., (i) it rarely accords with business reality from a Balance Sheet point of view, and (ii) during periods of inflation it tends to state inventories at lower than actual cost. The main advantage of this method is that it provides management with profits information based on comparing sales with current production costs.

Specific identification method: Under this method, specific costs are attributed to identified goods that have been produced or purchased and are segregated for a specific purpose.

Base stock method: Under this method, it is assumed that a minimum quantity of inventory known as ‘base stock’ is necessary at all times to carry on business. Inventories up to this level are valued at the cost at which base stock was acquired. Inventories beyond this level are valued by using any one of the above methods. This method has only a limited application since it requires a clear existence of the circumstances that a minimum level of inventory is required at all times to carry on business.

Net Realizable Value

Net realizable value (NRV) is the amount estimated to be realized from the disposal of stocks in the ordinary course of business, either in their existing condition or as incorporated in the products normally sold, after deducting all costs of completion and disposal. For this purpose, selling prices should be net of trade discounts. The costs which have to be incurred for the purpose of bringing the inventories to the state in which they are normally sold to customers are the costs of completion.

As observed at the very outset, in accordance with the principle of conservatism, inventories should not be shown in the financial statements in excess of amounts expected to be realized in the ordinary course of business. In other words, the basic principle of valuation of inventories should be historical cost or net realizable value, whichever is lower. This is because historical cost of inventories may not be realized under certain circumstances. For example, there could be a permanent fall in selling prices, or the items may have become wholly or partially obsolete, or the quantity of inventories may be so large that it is unlikely that they will be sold or utilized within the normal turnover period. In all such cases, it is necessary to write down inventories to net realizable value so that the loss in profit earning capacity is recognized in the period in which it becomes apparent.

Historical cost and net realisable value can be compared in respect of each item of inventory, or for groups of similar interchangeable articles separately. But the total of all dissimilar and non interchangeable items or all the inventories on an overall basis should not be compared since it may result in setting off loss against unrealized profit.

Normal quantities of materials and other supplies held for use in production are not written down below historical cost where the finished products are expected to be sold at or above historical cost. Similarly inventories of maintenance supplies and consumable stores are ordinarily valued at cost although they are valued at less than cost in appropriate cases.

6.2.2 Valuation and Verification of Liabilities

Liabilities refer to a company's legal debts or obligations that arise during the course of business operations. They include loans and borrowings, trade creditors and other current liabilities, deferred payments, instalments to be paid, etc. These are settled over time through the transfer of economic benefits including money, goods or services.

Verification of liabilities is an extremely important part of auditing, as without this, the balance sheet of a company will not reflect an accurate picture of the company's financial status.

Verification of liabilities is carried out by the following steps:

- Analysis of records
- Direct confirmation procedure
- Examination of disclosure
- Analytical review procedures
- Obtaining management representations

1. Sundry Creditors

Internal controls relating to trade creditors are closely associated with internal controls relating to purchases. As such they are discussed together in the following paragraphs.

Internal controls relating to purchases and trade creditors should be so devised as to ensure that proper controls are in operation in the areas of authorization, custody and recording procedures. In particular, it should be ensured that –

(a) the goods ordered for are those the organization requires, the right quantity and the right quality and they are obtained on the most advantageous terms;

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(b) the goods received are in accordance with those ordered for;

(c) the goods received and accepted are properly recorded in the books during the period to which they relate;

(d) the payments are made in respect of goods accepted;

(e) credit is obtained in respect of goods returned.

2. Outstanding Expenses

Outstanding expenses include prepayments, accrued income, unearned income and unpaid expenses. It may be recalled that one of the fundamental accounting concepts which underlies the preparation of periodic financial statements of a business enterprise is the 'accruals concept' which states that revenue and costs are accrued, i.e., they are recognized as they are earned or incurred, not as money received or paid. Hence, it is important that all items of prepayments, accrued income, unearned income and unpaid expenses should be brought into account in the preparation of financial statements. It is equally important that accrued income is brought into account only if there is reasonable certainty that such income will be received in due course.

Expenses incurred during the current financial year but a part of which relates to subsequent periods should be appropriately be apportioned as between the periods during which the benefit will be received. Insurance prepaid, rent and rates prepaid, advertising charges prepaid, commission prepaid, office stationery bought in advance, spare parts for motor vehicles and machinery bought in advance, etc., are examples of such prepayments. The apportionment of such expenses may be made on a time basis or on a revenue basis or on an inventory basis. For example, insurance prepaid could be apportioned on a time basis; advertising charges prepaid could be apportioned on the basis of the revenue produced by the same; office stationery bought in advance could be apportioned on the basis of the actual physical consumption of the stationery. It may be noted that for balance sheet purposes prepayments and accrued income should be treated as outstanding assets.

Outstanding liabilities: As in the case of outstanding assets mentioned in the above paragraph, there could be outstanding liabilities in respect of unearned income (e.g., rent received in advance) and/or unpaid expenses (e.g., rent for that part of the period coinciding with the date of the financial statements, but before the regular date on which rent is paid; wages and salaries due as at the date of the financial statements, but before the regular pay date; interest payable till the date of the financial statements; etc.). Necessary adjustments should be made in the financial statements in respect of such outstanding liabilities.

Audit procedures in relation to prepayments, accrued income, unearned income and unpaid expenses

- Arrange for a listing of the items of prepayments, accrued income, unearned income and unpaid expenses for the current financial period and compare

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this list with a similar list for the previous period and investigate into any material variations.

- Review the lists of expenses for material items where a prepayment or unpaid expense could be expected. Examples of such expenses include rent, rates, insurance, office stationery, interest, etc. Carry out further investigations wherever necessary.
- Make sure that the necessary adjusting entries are made in the impersonal ledger.
- Ensure that the necessary adjustments are made in the profit and loss account and balance sheet.
- Scrutinize the cash book records for the period immediately following the date of the financial statements in order to identify any items which relate to the period under review.

3. Contingent Liabilities

According to the Accounting Statement AS4 issued by the Institute of Chartered Accountants of India, 'a contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined on the occurrence or non-occurrence of one or more uncertain future events'. Contingent gains are not generally accounted for in the financial statements in the light of the prudence concept. But contingent liabilities are accounted for in the financial statements.

Contingent liabilities are possible liabilities of presently determinable amounts or indeterminable amounts that have arisen from past dealings or actions which may not become legal obligations in future. The uncertainty as to whether any legal obligation will arise is the distinguishing feature of contingent liabilities. This uncertainty distinguishes them from actual liabilities for which provisions are required in the financial statements. Contingent liabilities may arise from a number of sources such as:

- pending law suits against the client in respect of faulty goods, infringement of patent rights and other alleged breaches of contracts;
- bills discounted;
- debts sold to factors, with recourse;
- product warranties or guarantees;
- guarantees given on behalf of directors or officers of the client entity or on behalf of subsidiary companies;
- contracts signed but which have yet to be carried out either fully or partly.

It may be noted that contingent liabilities will not be recorded in the books of account.

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The auditor should first seek information from the management of the client entity concerning the estimates of contingent liabilities and should obtain a written assurance from the appropriate official or director concerned that he/she is not aware of any contingent liability other than those disclosed. Normally, this is included in the letter of representation obtained from the management. During the course of the audit, the auditor should be alive to the possibility of contingent liabilities being in existence. In addition, the following audit procedures may be undertaken to identify the existence of contingent liabilities, especially in relation to pending legal claims against the client:

- Evaluate the system in operation in the client entity for recording claims and the procedures followed for bringing them to the attention of the management.
- Examine correspondence with third parties/solicitors for any evidence of legal claims.
- Examine the minutes of the Board of directors or other appropriate committee for any evidence of legal claims.
- Obtain a list of matters referred to solicitors from the management of the client entity concerning legal claims with estimates of potential liability.

In those cases where matters have been referred to solicitors for advice or action, the auditor should request the client to advice the solicitors to furnish the auditor with details of the claims together with an estimate of the likely outcome of each claim. The reply from the solicitor should be sent direct to the auditor. In appropriate cases, it would be advisable for the auditor and the client to arrange a meeting with the solicitors to discuss the position.

On the basis of enquiries on the above lines, if the auditor is satisfied, absence of corroboration of the completeness of a list of legal claims need not be considered as a sufficient reason to qualify the audit report. On the other hand, where the auditor discovers matters not previously identified as a result of his enquiries or where material claims are outstanding and the auditor is unable to obtain sufficient appropriate evidence to enable him to a conclusion, then a qualification to the audit report is inevitable and the reasons for the qualification should be explained.

Disclosure of contingent liabilities: In the case of limited companies, the Companies Act stipulates that the following should be disclosed by way of notes to the financial statements:

- Claims against the company which are not acknowledged as debts.
- Where partly paid shares are held, the amount of liability in respect of uncalled capital.
- Arrears of fixed cumulative dividend.
- Estimates of contracts remaining to be executed on capital account and not provided for.

- Guarantees executed by the company on behalf of directors and other officers of the company together with the general nature of each such contingent liability, if material.
- All other contingent liabilities.
- Where a contingent liability is disclosed, the following information should be given in the financial statements:
- the nature of the contingency;
- the uncertainties which affect the future outcome;
- an estimate of the financial effect made at the date on which the financial statements are approved by the directors or a statement that such an estimate cannot be made.

Check Your Progress

1. Why do large manufacturing companies maintain fixed asset register?
2. What needs to be verified in case of items purchased on hire purchase?
3. How are inventories usually classified in the financial statements?
4. Which information is first sought by the auditor in case of verification of contingent liabilities?

6.3 DEPRECIATION

The Institute of Chartered Accountants in England and Wales defines 'depreciation' thus:

> Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent on the amount of profit earned.

The Committee on Terminology of the American Institute of Accountants describes depreciation accounting thus:

> Depreciation accounting is a system of accounting which aims at distributing the cost or other basic value of tangible capital assets, less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is intended to be a measure of all such occurrences.

In terms of the Statement on Standard Accounting Practice:

> Depreciation is a measure of the wearing out, consumption or other loss of value of a fixed asset whether arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation should be allocated to

accounting periods so as to charge a fair proportion to each accounting period during the expected useful life of the asset. Depreciation includes amortization of fixed assets whose useful life is predetermined (e.g., leases) and depletion of wasting assets (e.g., mines).

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Thus depreciation may be considered as the decrease in the utility value of a fixed asset over a period of time. This decrease in its value may arise from a variety of factors, some internal others external. Wear and tear in the case of such assets as plant and machinery or exhaustion in the case of wasting assets such as mines and quarries may be considered as examples of internal depreciation which arises from the operation of any cause natural to, or inherent in the asset itself. It may be noted in this connection that depletion is the term used to indicate the measure of exhaustion of a wasting asset, as its known or estimated resources are extracted.

Obsolescence or effluxion of time are instances of external depreciation. Such depreciation arises as a result of forces outside the asset itself. Obsolescence indicates the loss of value of a fixed asset mainly due to changes in economic conditions, such as changes in consumption habits or methods and techniques of production. These developments nay render the asset out of date, in spite of the fact that the asset is comparatively new. For example, a new invention may lower the cost of production substantially which, in turn, will have the effect of rendering the existing machine obsolete. Unless the existing machine is replaced, the business may find it difficult to withstand the competition from its rivals who make use of the new invention. Businesses which make extensive use of the products of advanced technology are susceptible to this form of depreciation because of scientific developments taking place within a short period.

Depreciation due to effluxion of time takes place in the case of fixed assets with a known life. They become exhausted simply by the passage of time. For example, leases, copyrights, patents, etc. Amortization is the term used to indicate depreciation provided on such assets. Thus, the cost of a 15-year lease would be amortized over its known life of 15 years since its utility value to the lease holder will become nil at the end of this period.

Assessment of Depreciation

The important factors in computing the rate of depreciation are as follows:

- The cost of the asset.
- Its effective life and the degree of use to which it will be put.
- The residual value which it will fetch at the end of its effective life.
- Foreseeable risk of obsolescence.

Of these, the cost of the asset can be ascertained exactly. In this connection it is sometimes pointed out that depreciation of an asset should be based on the replacement value of the asset and not on the original cost. The reason advanced in support of this view is that as a result of the changes which have taken place in

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the purchasing power of money, the original cost of a fixed asset is far below its current replacement price and if depreciation is provided on the basis of the original cost the amounts accumulated out of profits for replacement of the asset will be quite inadequate. Although this argument contains an element of truth, it should be remembered that the main object of providing for depreciation is not to provide a fund for the replacement of the asset (this may be its incidental and useful result) but for accounting as an expense the cost of using it up. Depreciation is first and foremost the recovery, spread over the life of the asset, of the prepaid cost incurred by its acquisition. In the opinion of leading professional bodies, provision for depreciation should be on the basis of historical cost; but where it is anticipated that the cost of replacing an asset will be generally in excess of its original cost an additional amount should be set aside to provide the additional funds that will eventually be required for replacement. Such an additional amount should not be treated as a provision which must be made before profits for the year can be ascertained; but as a transfer to reserves which is an appropriation of profits rather than a charge against them. Thus the basic depreciation would continue to be deducted from the book value of the assets in the balance sheet and the supplementary depreciation brought to a special replacement reserve account.

In many cases the second factor, viz., the effective life of the asset and the degree of use to which it will be put, is not susceptible of precise calculation. For example, the effective life of the asset is curtailed to a great extent on the necessity of shift working. On the other hand, its commercially useful life is prolonged as a result of exceptional maintenance expenditure. Assessment of such factors to arrive at an appropriate rate of depreciation will greatly be facilitated by the maintenance of a fixed assets register, the details of which are mentioned elsewhere. Of course, there are certain fixed assets like leases where the effective life of the asset can be ascertained exactly and hence the loss occasioned by effluxion of time can be calculated precisely.

The residual value which the asset will fetch at the end of its effective life is also a matter of estimation. It is recommended that where the residual value is likely to be small in relation to cost it is convenient to regard it as ‘nil’ and to deal with any proceeds on eventual disposal in the same way as depreciation over provided on disposal, viz., by showing this in the results of the year and disclosing it separately if material.

Risk of obsolescence cannot be foreseen with any degree of accuracy. It may briefly be repeated here that in the case of businesses which make extensive use of the products of advanced technology, where considerable improvements take place within relatively short periods of time, the chances of obsolescence are high.

To sum up, provisions for depreciation in most cases matters of estimation, based upon the available experience and knowledge, rather than of accurate determination. They require adjustments from time to time in the light of changes including prolongation of useful life due to exceptional maintenance expenditure, curtailment due to excessive use, or obsolescence not allowed for in the original estimate of the commercially useful life of the asset.

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Auditor's Position Regarding Depreciation

The auditor is generally not in a position to estimate the working life of most of the assets of a company. He needs to rely on the inputs provided by others, such as technical experts for machinery, etc. however, he is responsible for ensuring that the process of valuation is honest and transparent.

1. A method of depreciation appropriate in each particular case should be adopted.
2. The fixed assets register should be examined to ascertain the cost of each asset, the provision made for its depreciation, and the bases of provisions made.
3. It should be ensured that the amount of depreciation provided is neither too small nor too great.
4. In the case of a limited company, the relevant provisions in the Companies Act, explained earlier, should be adhered to.
5. The method adopted should be followed consistently. Otherwise the usefulness of periodic accounts for the purpose of comparison of one period with another will be vitiated.
6. Where the auditor is of the opinion that the provision made for depreciation is insufficient, and he is unable to induce his client to adopt his point of view, the matter should be dealt with in the audit report.

Change in the method of computing depreciation

As observed earlier, whatever method and rate of depreciation used, the provision for depreciation should be applied on a consistent basis from one period to another. Any change in the basis of providing depreciation from one year to another amounts to a change in the method of accounting, the result of which in terms of profits should be disclosed by way of a note to the profit and loss account. A switch over from the straight line method to the reducing balance method is an instance of such a change. Also, should the rates of depreciation be changed in a particular year, the effect on the profits should be explained in the note, if material.

Where a company revalues its assets to a higher figure, the depreciation provided on the revalued figures would be higher than the depreciation figure computed on the asset figure before revaluation. According to the Research Committee of the Institute of Chartered Accountants of India, under such circumstances it would appear that a note would not be strictly necessary as the effect of revaluation would be apparent from the face of the accounts. However, in the Committee's opinion, it would be desirable to insert an explanatory note.

Check Your Progress

5. What is amortization?
6. Give examples of external depreciation of assets.

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6.4 RESERVES, PROVISIONS AND SECRET RESERVES AND AUDITOR'S POSITION

Reserves are amounts that are earmarked by an entity from its retained earnings for future use, e.g., for meeting likely-to-be incurred bad debts. They are appropriations of profits. A provision is a liability of uncertain timing or amount. A present obligation of an entity arising from past events, the settlement of which will result in an outflow of resources is a liability. A provision is recognized if (i) an entity has a present obligation resulting from a past event, (ii) an outflow of resources will be necessary, and (iii) it is possible to make a reliable estimate of the amount of the obligation. Provision for legal claims is an example. Provision for bad debt is another example. In terms of generally accepted accounting principles and international financial reporting standards, a company has to report the allowances for doubtful items in the balance sheet and bad debts in the profit and loss account.

Kinds of Reserves

There are different kinds of reserves created and maintained by companies. The differences arise on account of the purpose for their creation and the source of their creation.

(i) Specific Reserve — Auditor's Duties

A specific reserve is a reserve created by appropriation of profits in order to meet a definite purpose or to comply with the provisions in the Articles of Association or in terms of a decision by the board of directors. In addition, certain types of specific reserves may be required to be created in terms of contractual obligations or legal compulsion. Debenture Redemption Reserve is an example of the former and Development Rebate Reserve is an example of the latter. Generally speaking, specific reserves are available for dividend payments on the recommendation of the board of directors, subject to the approval of the shareholders. At the same time, certain kinds of specific reserves cannot be used for dividend payments.

Examples of specific reserves include: (i) debenture redemption reserve created with a view to redeem the debentures by transferring a part of the profit every year; (ii) capital redemption reserve created where preference shares are to be redeemed out of profit in terms of Section 55 of the Companies Act; (iii) dividend equalization reserve created with the object of making payment of dividends at stable rates in different years irrespective of the profit earned;

(iv) foreign project reserve created out of profits earned from foreign projects (the amount credited to the reserve has to be utilized within a period of 5 years for the purpose of the business itself and it is eligible for availing deduction and (v) staff welfare reserve created for carrying on welfare activities of the members of staff of the entity.

Although creation of specific reserves does not alter the 'true and fair' view of the financial statements, the auditor has certain duties in relation to specific reserves, especially in the case of specific reserves which are to be created in terms of contractual obligations or legal compulsions. Their adequacy has to be verified and the auditor should ensure that they are not used for any purpose other than that for which they are created. Failure to do so will make the auditor guilty of negligence.

The steps which the auditor should follow in connection with specific reserves are:

1. Peruse the Articles of Association to see whether there is any provision to create specific reserves.
2. Examine the directors' minute book to see whether any decision has been taken for the creation of any specific reserve in which case whether the decision has been given effect to by the creation of the reserve concerned.
3. Examine the balance sheet to ensure that the specific reserves created have been shown in the balance sheet according to the requirement of Part I of schedule III of the Companies Act.
4. Examine the related documents such as debenture trust deed to ensure that sufficient provision has been made in terms of the legal requirements and the utilization of the reserve, if any, has been done according to legal provisions.

(ii) General Reserve

By transferring a certain amount of profit from the account of retained earnings to the general reserve account, a general reserve is created. This is done to meet potential future unknown liabilities. American Institute of Accountants states that 'the use of the term reserve is limited to indicate that an undivided portion of the asset is being held or retained for general or specific purposes.'

(iii) Capital Reserve

A capital reserve is a reserve created out of capital profits. A capital profit is one which does not arise in the normal course of business. Capital reserves are created out of the profits earned on the sale of fixed assets at prices above the cost, profits earned on revaluation of assets, profits earned prior to incorporation of the company, profits on reissue of forfeited shares, etc. Capital reserve is defined in the Companies Act according to which it is a reserve which does not include any amount regarded as free for distribution through profit and loss account.

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Normally, a capital reserve can be used for two purposes, viz., (i) for the issue of bonus shares subject to an appropriate provision in the Articles of Association, and (ii) for writing off intangible and fictitious assets.

Companies Act does not specifically indicate whether capital reserves can be made available for dividend payments. In this connection cases such as Lubbock Vs The British Bank of South America and Foster Vs The New Trinidad Lake Asphalte Co Ltd throw light on the issue. In the former case: It was held that profit made on the sale of a part of the undertaking could be distributed as dividends, subject to the relevant permission in the articles of association. In the latter case, it was held that a realized appreciation in the value of one of the items of capital assets could not be deemed to be profits divisible among the shareholders, unless such surplus remains after a revaluation of the whole of the assets.

(iv) Secret Reserves

Secret reserves are reserves which are not disclosed in the balance sheet. They are also known as 'hidden reserves' or 'internal reserves' or 'inner reserves'. They represent the surplus of assets over liabilities and capital. They do not appear in the ledger.

Secret reserves are created by adopting such measures as charging capital expenditure to revenue, providing excessive depreciation/ excessive provision for bad and doubtful debts/ excessive discounts on sundry debtors, writing down goodwill to nominal value, undervaluing stock in trade, omitting some assets altogether from the books, showing contingent liabilities as actual liabilities, overvaluing liabilities, suppressing sales figures, etc.

Secret Reserves — Their Usefulness and Effects

Secret reserves are created for different objectives. These objectives may be summarized as: meeting an extraordinary loss in future without disclosing the fact to the shareholders, strengthening the financial position of the entity, misleading trade competitors about the financial position of the company, manipulating prices of shares in the stock market, evading income tax and wealth tax, equalizing dividends (thus maintaining the financial stability of the company, etc.

Objections to creation of secret reserves

Creation of secret reserves is objected to on the following grounds:

(i) Balance sheet will not show a 'true and fair' view of the state of affairs of the company as required by the Companies Act. So also, the profit and loss account will not give a 'true and fair' view of the profit/loss of the company because of the provision of excessive depreciation/excessive provision for bad and doubtful debts, etc. In short, secret reserves make the information disclosed by the financial statements false and incorrect.

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(ii) Directors of the company may make use of the secret reserves to conceal their weakness in terms of mismanagement. In other words, secret reserves may cover up the inefficiency and fraud committed by the directors.

(iii) Where secret reserves are created by undervaluation of assets and an accident like fire occurs in the premises, the company will not be able to claim the full value of the assets since the insurance company will pay according to the book value of the assets.

(iv) Secret reserves may enable members of the management of the company to indulge in speculation in the shares of the company for their own benefit.

(v) Value of the shares will be affected adversely in the share market.

Duties of an Auditor

Auditor's duty is to report whether the financial statements show a 'true and fair' view as at the date of such statements. Creation of secret reserves will go against the' true and fair' view. As such, the duty of the auditor is obvious and he/she will not be justified in reporting that the financial statements show a 'true and fair' view in case secret reserves exist. Even when such reserves have been created with honest intentions such as to strengthen the financial position of the company, the auditor's position is not altered. He/she will have to qualify the report by stating that the financial statements do not show a 'true and fair' view.

Certain types of companies are permitted to create secret reserves. Even in their case, the auditor should ascertain the magnitude and the necessity of the creation of such reserves. Where he/she is satisfied that they have been created in the best interests of the company and that they are reasonable, the auditor is justified in not qualifying the report.

It may be noted in this connection that a provision in the Articles of Association of the company forbidding the auditor from disclosing the fact concerning secret reserves is ultra vires the statutory duty of the auditor.

Check Your Progress

7. Give examples of specific reserve created as per contractual obligation and legal compulsion.
8. Mention the two purposes for which a capital reserve can be used.
9. Define secret reserves.

6.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Large manufacturing companies invariably maintain a register of their fixed assets in order to control an identify the assets that have been acquired for permanent use in the business.

2. Where the items are purchased on hire purchase or instalment system, examine the relevant agreements. Make sure that the amounts outstanding along with interest and other charges are shown as liability. Check the computation of hire purchase interest and see that the allocation to revenue is correct.
3. Inventories are normally classified in the financial statements under the following heads:
   - Raw materials and components
   - Work-in-process
   - Finished goods
   - Stores and spares
4. In case of verification of contingent liabilities, the auditor should first seek information from the management of the client entity concerning the estimates of contingent liabilities and should obtain a written assurance from the appropriate official or director concerned that he/she is not aware of any contingent liability other than those disclosed. Normally, this is included in the letter of representation obtained from the management.
5. Depreciation due to effluxion of time takes place in the case of fixed assets with a known life. They become exhausted simply by the passage of time. For example, leases, copyrights, patents, etc. Amortization is the term used to indicate depreciation provided on such assets.
6. Obsolescence and effluxion of time are instances of external depreciation of assets.
7. Debenture Redemption Reserve is an example of specific reserve created for contractual obligation while Development Rebate Reserve is an example of specific reserve created as a part of legal compulsion.
8. A capital reserve can be used for two purpose, viz., (i) for the issue of bonus shares subject to an appropriate provision in the Articles of Association, and (ii) for writing off intangible and fictitious assets.
9. Secret reserves are reserves which are not disclosed in the balance sheet. They are also known as ‘hidden reserves or internal reserves or inner reserves. They represent the surplus of assets over liabilities and capital.

6.6 SUMMARY

- The term ‘asset’ refers to a resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide future benefit. Assets can be of two types – fixed and current.
- Fixed assets are those assets acquired by a business for the purpose of use in the business with the object of earning revenue and which are not intended

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for resale at a profit or conversion into cash in the ordinary course of business. They may be tangible assets or intangible assets. They are valued on the going concern basis.

- Before carrying out detailed audit tests on fixed assets, the auditor should examine the internal control procedures relating to them.
- Large manufacturing companies should maintain a fixed asset register. There are certain reasons for maintaining such a register.
- The general audit objectives in connection with fixed assets are (i) completeness, (ii) existence, (iii) ownership, (iv) valuation, and (v) disclosure.
- There are some differences between verification and valuation.
- Auditor's position as regards valuation of assets is that an auditor is not a valuer and he/she cannot be expected to act as such.
- In relation to specified categories of fixed assets such as goodwill, land and buildings, plant and machinery, patents and trademarks and investments, there are certain points to be noted in addition to the audit approach applicable to fixed assets in general.
- Current assets are cash and those assets acquired by a business for subsequent conversion into cash. The basic principle of their valuation is cost price or market price whichever is lower. In relation to the verification and valuation of current assets such as cash in hand, cash at bank, sundry debtors, stock in trade, the auditor has certain duties.
- In relation to verification and valuation of liabilities such as sundry creditors, outstanding expenses and contingent liabilities, the auditor has certain duties to perform.
- Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him/her.
- Depreciation may be considered as a decrease in the utility value of a fixed asset over a period of time. This decrease in its value may arise from a variety of factors, some internal others external. Wear and tear, exhaustion and depletion are examples of internal depreciation. Obsolescence or effluxion of time are instances of external depreciation.
- Depreciation is based or assessed and the rate of depreciation is computed taking into consideration certain factors.
- The auditor has certain duties as regards depreciation.
- While reserves refer to the amounts that are earmarked by an entity from its retained earnings for future use, provision is a liability of uncertain timing or amount.
- There are different kinds of reserves created and maintained by companies and the auditor's duties in case of these changes as per the nature of these

reserves: specific reserves, general reserves, capital reserves and secret reserves.

6.7 KEY WORDS

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- **Valuation of assets:** It is a method of assessing the worth of a company, real property, security, antique or other item of worth. It is commonly performed prior to the sale of an asset or prior to purchasing insurance for an asset.
- **Verification of assets:** It is a process conducted by auditors to confirm that a company's assets actually exist.
- **Depreciation**: It refers to that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally put out of use by him.
- **Reserves:** It refers to the amounts that are earmarked by an entity from its retained earnings for future use.
- **Provision:** It is a liability of uncertain timing or amount.

6.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Define the term 'asset' and explain the types of assets with examples.
2. Differentiate between valuation and verification of assets.
3. Briefly explain the auditor's position as regards valuation of assets.
4. What are the different methods of computing costs?
5. Mention the important factors in assessing depreciation.
6. What are the auditor's duties as regards depreciation?
7. Mention the differences between provisions and reserves.

Long Answer Questions

1. Explain the process of verification and valuation of fixed assets.
2. What are current assets? Explain the internal controls relating to the different types of current assets.
3. Explain the verification and valuation of stock in trade (inventories).
4. What are liabilities? Explain the internal controls relating to sundry trade creditors, outstanding expenses and contingent liabilities.
5. Describe the various kinds of reserves and the duties of an auditor with regards to them.

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6.9 FURTHER READINGS

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Shekhar, L and K C Shekhar. 2003. *Auditing, 20th edition*. Delhi: Vikas Publishing House.

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UNIT 7 COMPANY AUDIT - I

Structure

7.0 Introduction
7.1 Objectives
7.2 Appointment and Remuneration of Auditors
  7.2.1 Removal of Auditors and Procedure for Removal
7.3 Answers to Check Your Progress Questions
7.4 Summary
7.5 Key Words
7.6 Self Assessment Questions and Exercises
7.7 Further Readingss

7.0 INTRODUCTION

In the last unit, we studied about the assets and liabilities of a company and understood how important they were in obtaining a clear picture of a company's financial health. This is possible only with the help of auditors, who play a vital role in a company. Auditors examine several aspects of the business, including employees, apart from checking the financial records. They keep track of the company's assets and liabilities, as well as ensure the efficient use of resources in order to serve an organization best. Based on their analysis of these aspects, they put forward solutions for rectifying financial imbalance and other unprofitable areas in a company. In this unit, you will learn about the appointment, remuneration and removal of company auditors.

7.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the provisions related to the appointment and remuneration of auditors
- Describe the provisions related to the removal of company auditors

7.2 APPOINTMENT AND REMUNERATION OF AUDITORS

Section 139 of the Companies Act 2013, lays down provisions related to the appointment of company auditors.

Process of Appointment

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As per Section 139 (*1*) Subject to the provisions of this Chapter, every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and the manner and procedure of selection of auditors by the members of the company at such meeting shall be such as may be prescribed:

Provided that the company shall place the matter relating to such appointment for ratification by members at every annual general meeting:

Provided further that before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor:

Provided also that the certificate shall also indicate whether the auditor satisfies the criteria provided in section 141:

Provided also that the company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed.

Explanation.—For the purposes of this Chapter, "appointment" includes reappointment.

Rules regarding Duration of Appointment and Re-appointment

Section 139 (*2*) says: No listed company or a company belonging to such class or classes of companies as may be prescribed, shall appoint or re-appoint—

(*a*) an individual as auditor for more than one term of five consecutive years; and

(*b*) an audit firm as auditor for more than two terms of five consecutive years:

Provided that—

(*i*) an individual auditor who has completed his term under clause (*a*) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term;

(*ii*) an audit firm which has completed its term under clause (*b*), shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such term:

Provided further that as on the date of appointment no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years:

Provided also that every company, existing on or before the commencement of this Act which is required to comply with provisions of this sub-section, shall comply with the requirements of this sub-section within three years from the date of commencement of this Act:

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Provided also that, nothing contained in this sub-section shall prejudice the right of the company to remove an auditor or the right of the auditor to resign from such office of the company.

On rotation of Auditors

Section 139 (*3*) says: Subject to the provisions of this Act, members of a company may resolve to provide that—

(*a*) in the audit firm appointed by it, the auditing partner and his team shall be rotated at such intervals as may be resolved by members; or

(*b*) the audit shall be conducted by more than one auditor.

Section 139 (*4*) says: The Central Government may, by rules, prescribe the manner in which the companies shall rotate their auditors in pursuance of sub-section (*2*).

Explanation.—For the purposes of this Chapter, the word "firm" shall include a limited liability partnership incorporated under the Limited Liability Partnership Act, 2008.

Appointment in Case of Government Company Auditor By CAG

Section 139 (*5*) says: Notwithstanding anything contained in sub-section (*1*), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of one hundred and eighty days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

On the First Auditor by the Board of Directors

Section 139 (*6*) Notwithstanding anything contained in sub-section (*1*), the first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within thirty days from the date of registration of the company and in the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.

On the First Auditor by the CAG in case of Government Companies

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Section 139 (*7*) Notwithstanding anything contained in sub-section (*1*) or sub-section (*5*), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor shall be appointed by the Comptroller and Auditor-General of India within sixty days from the date of registration of the company and in case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.

On Casual Vacancy

As per Section 139 (*8*) Any casual vacancy in the office of an auditor shall—

(*i*) in the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;

(*ii*) in the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within thirty days: Provided that in case the Comptroller and Auditor-General of India does not fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next thirty days.

On Re-appointment of Retiring Auditor

Section 139 (*9*) says: Subject to the provisions of sub-section (*1*) and the rules made thereunder, a retiring auditor may be re-appointed at an annual general meeting, if—

(*a*) he is not disqualified for re-appointment;

(*b*) he has not given the company a notice in writing of his unwillingness to be re-appointed; and

(*c*) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

On Continuing of Existing Auditor

Section 139 (*10*) says Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

On the Recommendation of Audit Committee

Section (*11*) Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

Requirement for Special Notice for Appointing a Person other than Retiring Auditor

The following is the provision mentioned in sub-sections 4 of Section 140 of the Companies Act 2013 in relation to appointing a person other than retiring auditor:

(4) (i) Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139.

(ii) On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

(iii) Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,—

(a) in any notice of the resolution given to members of the company, state the fact of the representation having been made; and

(b) send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company,

and if a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting:

Provided that if a copy of representation is not sent as aforesaid, a copy thereof shall be filed with the Registrar:

*Provided further that if the Tribunal is satisfied on an application either of the company or of any other aggrieved person that the rights conferred by this sub-section are being abused by the auditor, then, the copy of the representation may not be sent and the representation need not be read out at the meeting.

Auditor's remuneration

The following are the provisions mentioned in Section 142 of the Companies Act 2013 in relation to the remuneration of auditors:

(1) The remuneration of the auditor of a company is to be fixed in its general meeting or in such manner as may be determined therein:

Provided that the Board may fix remuneration of the first auditor appointed by it.

(2) The remuneration under sub-section (1) shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him but does not include any remuneration paid to him for any other service rendered by him at the request of the company.

7.2.1 Removal of Auditors and Procedure for Removal

The following are the provisions mentioned in Section 140 of the Companies Act 2013 in relation to the removal and procedure of removal of auditors:

1. The auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the #Central Government in that behalf in the prescribed manner:

   Provided that before taking any action under this sub-section, the auditor concerned shall be given a reasonable opportunity of being heard.

2. The auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form with the company and the Registrar, and in case of companies referred to in sub-section (5) of section 139, the auditor shall also file such statement with the Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation.

3. If the auditor does not comply with the provisions of sub-section (2), he or it shall be liable to a penalty of fifty thousand rupees or an amount equal to the remuneration of the auditor, whichever is less, and in case of continuing failure, with further penalty of five hundred rupees for each day after the first during which such failure continues, subject to a maximum of two lakh rupees.

Power of the Tribunal in Removal of Auditor

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Sub-section 5 of Section 140 deals with the powers of the Tribunal:

(5) Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either suo moto or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors:

Provided that if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place:

Provided further that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

Explanation I.—It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.

Explanation II.—For the purposes of this Chapter the word "auditor" includes a firm of auditors.

Check Your Progress

1. Mention the period till which an auditor holds office as per the Companies Act.
2. List the conditions under an auditor can be re-appointed.
3. What is the condition of removal of the auditor before the expiry of his term as per the Companies Act?

7.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. As per the Companies Act, every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and

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the manner and procedure of selection of auditors by the members of the company at such meeting shall be such as may be prescribed.

2. A retiring auditor may be re-appointed at an annual general meeting, if—
   (*a*) he is not disqualified for re-appointment;
   (*b*) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
   (*c*) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.
3. As per the Section 140 (1) of the Companies Act 2013, the auditor under Section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf in the prescribed manner.

7.4 SUMMARY

- Auditors of limited companies are appointed in terms of the provisions of the Companies Act, 2013. At each annual general meeting (AGM), every company has to appoint an auditor to hold office until the next AGM.
- Elaborate requirements concerning the appointment, reappointment, removal and qualifications and disqualifications of auditors are incorporated in the legislation with a view to ensuring that the audit of the limited companies is carried out by persons possessing the necessary expertise.
- Section 139 of the Companies Act 2013, lays down provisions related to the appointment of company auditors.
- Section 142 deals with the provisions related to remuneration.
- Section 140 lays down the provision related to the removal of the auditor.

7.5 KEY WORDS

- **Company auditor:** It refers to authorized personnel who is tasked with checking and verifying the company in question is complying with the tax and companies' law applicable in the country and region.
- **Annual general meeting:** It refers to the meeting that is to be organized by companies which holds the interaction between the Board members and the shareholders of the company.
- **Suo moto:** It is a legal jargon referring to the action taken by the authority on its own accord without any request by the parties involved.

7.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. What is included in auditor's remuneration as per the Companies Act 2013?
2. Briefly explain the removal and procedure of removal of auditors.
3. Mention the powers of the Tribunal in case of removal of auditors.

Long Answer Questions

1. Explain the important provisions related to the appointment of company auditors as per the Companies Act 2013.
2. Discuss the provisions related to requirement of special notice in case of appointment of auditors as per Section 140 of the Companies Act 2013.

7.7 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

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UNIT 8 COMPANY AUDIT - II

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Structure

8.0 Introduction
8.1 Objectives
8.2 Duties of the Auditor
8.3 Auditor's Report: Basic Elements
8.4 Maintenance of Books and Records
8.4.1 Important Considerations
8.5 Types of Audit Report
8.6 Answers to Check Your Progress Questions
8.7 Summary
8.8 Key Words
8.9 Self Assessment Questions and Exercises
8.10 Further Readings

8.0 INTRODUCTION

The most important document of an auditor's communication is the auditor's report. The auditor's report is a formal opinion, or disclaimer thereof, issued by either an internal auditor or an independent external auditor as a result of an internal or external audit or evaluation performed on a legal entity or subdivision thereof (called an 'auditee'). The report is subsequently provided to a 'user' (such as an individual, a group of persons, a company, a government, or even the general public, among others) as an assurance service in order for the user to make decisions based on the results of the audit. In this unit, you will first learn about the duties of a company auditor followed by provisions related to the maintenance of books as per the Companies act and the types of audit report.

8.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the duties of the company auditor
- Explain the basic elements of an auditor's report
- Examine the provisions of the companies act with respect to the maintenance of books and records
- Describe the types of audit report

8.2 DUTIES OF THE AUDITOR

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This section discusses the important provisions related to the duties of auditors:

(1) Duty to Prepare Audit Report

Section 143 (2) says that:

The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

(2) Duty to Report Matters

Section 143 (3) mentions the matters on which must be stated in the auditor's report.

(a) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as 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;

(c) whether the report on the accounts of any branch office of the company audited under subsection (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

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(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

(3) Duty to prepare Audit report for Government Company

Section 143 (5) says In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Government, or partly by the Central Government and partly by one or more State Government, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section (5) or sub-section (7) of section 139 and direct such auditor the manner in which the accounts of the company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

(4) Duty to follow Auditing Standards

As per Section 143 (9) of the Act: Every auditor shall comply with the auditing standards.

Section 143 (10) says that: The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority:

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

(5) Duty to Report Frauds

Section 143 (12) says: Notwithstanding anything contained in this section, if an auditor of a company in the course of the performance of his duties as auditor, has reason to believe that an offence of fraud involving such amount or amounts as may be prescribed, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Central Government within such time and in such manner as may be prescribed:

Provided that in case of a fraud involving lesser than the specified amount, the auditor shall report the matter to the audit committee constituted under section 177 or to the Board in other cases within such time and in such manner as may be prescribed:

Provided further that the companies, whose auditors have reported frauds under this sub-section to the audit committee or the Board but not reported to the Central Government, shall disclose the details about such frauds in the Board's report in such manner as may be prescribed.

Section 143 (15) says that If any auditor, cost accountant, or company secretary in practice does not comply with the provisions of sub-section (12), he shall,—

(a) in case of a listed company, be liable to a penalty of five lakh rupees; and

(b) in case of any other company, be liable to a penalty of one lakh rupees.

8.3 AUDITOR'S REPORT: BASIC ELEMENTS

Format of the audit reports depend upon the objective of the audit, and its terms of engagement.

1. If the audit is being conducted under any statute, the audit report must be according to that statute itself, e.g., CARO 2016 for the companies as per Companies Act, 2013, Form 3C13, 3CD for the tax audit, VAT audit report under various VAT act, etc.
2. In case of any other case, the audit report format depends upon the auditor in agreement with the management of the organization.

An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor's report is 'essentially worthless' for investing purposes.

It is important that an audit report should include the following basic elements:

- **Title:** An audit report should contain an appropriate title, such as 'Auditor's Report' so as to distinguish it clearly from reports issued by the management or others.
- **Addressee:** The report should be appropriately addressed. For example, in the case of limited companies, the report is addressed to the members of the company concerned although it is true that many third parties may also place reliance on it.
- **Identification**: The users of financial statements should be able to identify the statements to which the audit report refers. Thus, the name of the client, business, date and period covered by the statements, page numbers of the statements to which the report relates, etc, should be clearly indicated.

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Where the pages are not numbered, the auditor may use such description as 'the Annexed Balance Sheet, Profit and Loss Account and Notes'. Sometimes, the management of a company may have taken advantage of the provisions in the Companies Act to include in the directors' report certain matters which the Act requires to be included in the Profit and Loss Account and Balance Sheet. In such cases, the auditor should make a reference to such information by clearly specifying the paragraphs of the directors' report which fall within its scope.

- **Reference to auditing standards:** It is advisable to make a reference to the auditing standards followed in carrying out the audit. This gives the users of financial statements an assurance that the audit has been carried out in accordance with established standards. Unless otherwise stated, the auditing standards followed are presumed to be those of the country indicated by the auditor's address.
- **Signature:** The report should be signed in the personal name of the auditor. As a matter of fact, in the case of limited companies, section 145 of the Indian Companies Act provides that only the person appointed as auditor of a company, or where a firm is so appointed, only a partner in the firm practising in India, may sign the auditor's report or authenticate any document of a company required by law to be signed or authenticated by the auditor. In exercise of the powers conferred by Clause (3) of Part III of the First Schedule of the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India has directed that in all cases where a firm of chartered accountants is appointed as auditor of a company under section 141 of the Companies Act, the member or partner of the firm, as the case may be, who signs the auditor's report on the accounts of the company or any other document of the company required by the Companies Act, to be signed or authenticated by the auditor, should, at the time he affixes his signature or within a reasonable period thereafter, write to the Registrar of Companies concerned, certifying the fact of his having signed the auditor's report or other documents of the company, and for the year, to be specified by him in the letter.
- **Address:** The report should specify the location of the auditor's office.
- **Date:** The date of the report should be clearly specified. This informs the users of the financial statements that the auditor considered, the effects on the financial statements and on his report of events or transactions about which he became aware that occurred up to that date.

Check Your Progress

1. What does Section 143(9) prescribe?
2. Mention the punishment in case auditors do not report frauds.

8.4 MAINTENANCE OF BOOKS AND RECORDS

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A company registered under the Act is required to maintain the following books. The relevant provisions are also given for ready reference.

Register of investments which are not held by the company in its own name (Section 187(3)): Where in pursuance of clause (d) of sub-section (2), any shares or securities in which investments have been made by a company are not held by it in its own name, the company shall maintain a register which shall contain such particulars as may be prescribed and such register shall be open to inspection by any member or debenture-holder of the company without any charge during business hours subject to such reasonable restrictions as the company may by its articles or in general meeting impose.

Register of Charges (Section 85(1))

(1) Every company shall keep at its registered office a register of charges in Form No. CHG.7 and enter therein particulars of all the charges registered with the Registrar on any of the property, assets or undertaking of the company and the particulars of any property acquired subject to a charge as well as particulars of any modification of a charge and satisfaction of charge.

(2) The entries in the register of charges maintained by the company shall be made forthwith after the creation, modification or satisfaction of charge, as the case may be.

(3) Entries in the register shall be authenticated by a director or the secretary of the company or any other person authorised by the Board for the purpose.

(4) The register of charges shall be preserved permanently and the instrument creating a charge or modification thereon shall be preserved for a period of eight years from the date of satisfaction of charge by the company.

Register of Members (Section 88(1))

Section 88 (1) Every company shall keep and maintain the following registers in such form and in such manner as may be prescribed, namely:—

(a) register of members indicating separately for each class of equity and preference shares held by each member residing in or outside India;

(b) register of debenture-holders; and

(c) register of any other security holders.

(1) Every company limited by shares shall, from the date of its registration, maintain a register of its members in Form No. MGT.1:

Provided that in the case of a company existing on the commencement of the Act, the particulars as available in the register of members maintained under the Companies Ac t, 1956 shall be transferred to the new register of members in

Form No.MGT-1 and in case additional information, required as per provisions of the Act and these rules, is provided by the members, such information may also be added in the register as and when provided.

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(2) In the case of a company not having share capital, the register of members shall contain the following particulars, in respect of each member, namely:-

(a) name of the member; address (registered office address in case the member is a body corporate); e-mail address; Permanent Account Number or CIN; Unique Identification Number, if any; Father's/Mother's/Spouse's name; Occupation; Status; Nationality; in case member is a minor, name of the guardian and the date of birth of the member; name and address of nominee;

(b) date of becoming member;

(c) date of cessation;

(d) amount of guarantee, if any;

(e) any other interest if any; and

(f) instructions, if any, given by the member with regard to sending of notices etc:

Provided that in the case of a company existing on the date of commencement of the Act, the particulars as available in the register of members maintained under the Companies Act, 1956 shall be transferred to the new register of members in Form No.MGT-1 and in case additional information, required as per provisions of the Act and these rules, is provided by the members, such information may also be added in the register as and when provided.

Index of Members (Section 88)

(1) Every register maintained under sub-section (1) of section 88 shall include an index of the names entered in the respective registers and the index shall, in respect of each folio, contain sufficient indication to enable the entries relating to that folio in the register to be readily found:

Provided that the maintenance of index is not necessary in case the number of members is less than fifty.

(2) The company shall make the necessary entries in the index simultaneously with the entry for allotment or transfer of any security in such Register.

Index of Beneficial Owners (Section 88(3)): The register and index of beneficial owners maintained by a depository under section 11 of the Depositories Act, 1996 (22 of 1996), shall be deemed to be the corresponding register and index for the purposes of this Act.

Foreign Register of Members, Debenture Holders, Other Security Holders or Beneficial Owners Residing Outside India (Section 88 (4)):

(1) A company which has share capital or which has issued debentures or any other security may, if so authorised by its articles, keep in any country outside

India, a part of the register of members or as the case may be, of debenture holders or of any other security holders or of beneficial owners, resident in that country (hereafter in this rule referred to as the "foreign register").

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(2) The company shall, within thirty days from the date of the opening of any foreign register, file with the Registrar notice of the situation of the office in Form No.MGT.3 along with the fee where such register is kept; and in the event of any change in the situation of such office or of its discontinuance, shall, within thirty days from the date of such change or discontinuance, as the case may be, file notice in Form No.MGT.3 with the Registrar of such change or discontinuance.

(3) A foreign register shall be deemed to be part of the company's register (hereafter in this rule referred to as the "principal register") of members or of debenture holders or of any other security holders or beneficial owners, as the case may be.

(4) The foreign register shall be maintained in the same format as the principal register.

(5) A foreign register shall be open to inspection and may be closed, and extracts may be taken there from and copies thereof may be required, in the same manner, *mutatis mutandis*, as is applicable to the principal register, except that the advertisement before closing the register shall be inserted in at least two newspapers circulating in the place wherein the foreign register is kept.

(6) If a foreign register is kept by a company in any country outside India, the decision of the appropriate competent authority in regard to the rectification of the register shall be binding.

(7) Entries in the foreign register maintained under sub-section (4) of section 88 shall be made simultaneously after the Board of Directors or its duly constituted committee approves the allotment or transfer of shares, debentures or any other securities, as the case may be.

(8) The company shall—

(a) transmit to its registered office in India a copy of every entry in any foreign register within fifteen days after the entry is made; and

(b) keep at such office a duplicate register of every foreign register duly entered up from time to time.

(9) Every such duplicate register shall, for all the purposes of this Act, be deemed to be part of the principal register.

(10) Subject to the provisions of section 88 and the rules made thereunder, with respect to duplicate registers, the shares or as the case may be, debentures or any other security, registered in any foreign register shall be distinguished from the shares or as the case may be, debentures or any other security, registered in the principal register and in every other foreign register; and no transaction with respect to any shares or as the case may be, debentures or

any other security, registered in a foreign register shall, during the continuance of that registration, be registered in any other register.

(11) The company may discontinue the keeping of any foreign register; and thereupon all entries in that register shall be transferred to some other foreign register kept by the company outside India or to the principal register.

Minutes of Proceedings of General Meeting, Meeting of Board of Directors and Other Meeting and Resolutions Passed by Postal Ballot (Section 118)

(1) Every company shall cause minutes of the proceedings of every general meeting of any class of shareholders or creditors, and every resolution passed by postal ballot and every meeting of its Board of Directors or of every committee of the Board, to be prepared and signed in such manner as may be prescribed and kept within thirty days of the conclusion of every such meeting concerned, or passing of resolution by postal ballot in books kept for that purpose with their pages consecutively numbered.

(2) The minutes of each meeting shall contain a fair and correct summary of the proceedings thereat.

(3) All appointments made at any of the meetings aforesaid shall be included in the minutes of the meeting.

(4) In the case of a meeting of the Board of Directors or of a committee of the Board, the minutes shall also contain-

  (a) the names of the directors present at the meeting; and

  (b) in the case of each resolution passed at the meeting, the names of the directors, if any, dissenting from, or not concurring with the resolution.

(5) There shall not be included in the minutes, any matter which, in the opinion of the Chairman of the meeting,-

  (a) is or could reasonably be regarded as defamatory of any person; or

  (b) is irrelevant or immaterial to the proceedings; or

  (c) is detrimental to the interests of the company.

(6) The Chairman shall exercise absolute discretion in regard to the inclusion or non-inclusion of any matter in the minutes on the grounds specified in sub-section (5).

(7) The minutes kept in accordance with the provisions of this section shall be evidence of the proceedings recorded therein.

(8) Where the minutes have been kept in accordance with sub-section (1) then, until the contrary is proved, the meeting shall be deemed to have been duly called and held, and all proceedings thereat to have duly taken place, and the resolutions passed by postal ballot to have been duly passed and in

particular, all appointments of directors, key managerial personnel, auditors or company secretary in practice, shall be deemed to be valid.

(9) No document purporting to be a report of the proceedings of any general meeting of a company shall be circulated or advertised at the expense of the company, unless it includes the matters required by this section to be contained in the minutes of the proceedings of such meeting.

Registers of Contracts, Companies and Firms in Which Directors are Interested (Section 189)

(1) Every company shall keep one or more registers giving separately the particulars of all contracts or arrangements to which sub-section (2) of section 184 or section 188 applies, in such manner and containing such particulars as may be prescribed and after entering the particulars, such register or registers shall be placed before the next meeting of the Board and signed by all the directors present at the meeting.

(2) Every director or key managerial personnel shall, within a period of thirty days of his appointment, or relinquishment of his office, as the case may be, disclose to the company the particulars specified in sub-section (1) of section 184 relating to his concern or interest in the other associations which are required to be included in the register under that sub-section or such other information relating to himself as may be prescribed.

(5) Nothing contained in sub-section (1) shall apply to any contract or arrangement—

(a) for the sale, purchase or supply of any goods, materials or services if the value of such goods and materials or the cost of such services does not exceed five lakh rupees in the aggregate in any year; or

(b) by a banking company for the collection of bills in the ordinary course of its business.

Here it is important to mention two important sections related to related party transactions and disclosure of interest by director.

Related Party Transactions (Section 188)

(1) Except with the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as may be prescribed, no company shall enter into any contract or arrangement with a related party with respect to-

(a) sale, purchase or supply of any goods or materials;

(b) selling or otherwise disposing of, or buying, property of any kind;

(c) leasing of property of any kind;

(d) availing or rendering of any services;

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(e) appointment of any agent for purchase or sale of goods, materials, services or property;

(f) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and

(g) underwriting the subscription of any securities or derivatives thereof, of the company:

Provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a resolution:

Provided further that no member of the company shall vote on such resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party:

Provided also that nothing contained in the second proviso shall apply to a company in which ninety per cent. or more members, in number, are relatives of promoters or are related parties:

Provided also that nothing in this sub-section shall apply to any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm's length basis.

Provided also that the requirement of passing the resolution under first proviso shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval:

Explanation.- In this sub-section,-

(a) the expression "office or place of profit" means any office or place-

  (i) where such office or place is held by a director, if the director holding it receives from the company anything by way of remuneration over and above the remuneration to which he is entitled as director, by way of salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;

  (ii) where such office or place is held by an individual other than a director or by any firm, private company or other body corporate, if the individual, firm, private company or body corporate holding it receives from the company anything by way of remuneration, salary, fee, commission, perquisites, any rent-free accommodation, or otherwise;

(b) the expression "arm's length transaction" means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

(2) Every contract or arrangement entered into under sub-section (1) shall be referred to in the Board's report to the shareholders along with the justification for entering into such contract or arrangement.

(3) Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by a resolution in the general meeting under sub-section (1) and if it is not ratified by the Board or, as the case may be, by the shareholders at a meeting within three months from the date on which such contract or arrangement was entered into, such contract or arrangement shall be voidable at the option of the Board or, as the case may be, of the shareholders and if the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it.

(4) Without prejudice to anything contained in sub-section (3), it shall be open to the company to proceed against a director or any other employee who had entered into such contract or arrangement in contravention of the provisions of this section for recovery of any loss sustained by it as a result of such contract or arrangement.

(5) Any director or any other employee of a company, who had entered into or authorised the contract or arrangement in violation of the provisions of this section shall,-

(i) in case of listed company, be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both; and

(ii) In case of any other company, be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees.

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Disclosure of interest by director (Section 184)

(1) Every director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the disclosures already made, then at the first Board meeting held after such change, disclose his concern or interest in any company or companies or bodies corporate, firms, or other association of individuals which shall include the shareholding, in such manner as may be prescribed.

(2) Every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement or proposed contract or arrangement entered into or to be entered into— (a) with a body corporate in which such director or such director in association with any other director, holds more than two per cent. shareholding of that body

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corporate, or is a promoter, manager, Chief Executive Officer of that body corporate; or (b) with a firm or other entity in which, such director is a partner, owner or member, as the case may be, shall disclose the nature of his concern or interest at the meeting of the Board in which the contract or arrangement is discussed and shall not participate in such meeting: Provided that where any director who is not so concerned or interested at the time of entering into such contract or arrangement, he shall, if he becomes concerned or interested after the contract or arrangement is entered into, disclose his concern or interest forthwith when he becomes concerned or interested or at the first meeting of the Board held after he becomes so concerned or interested.

(3) A contract or arrangement entered into by the company without disclosure under sub-section (2) or with participation by a director who is concerned or interested in any way, directly or indirectly, in the contract or arrangement, shall be voidable at the option of the company.

(4) If a director of the company contravenes the provisions of sub-section (1) or subsection (2), such director shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to one lakh rupees, or with both.

(5) Nothing in this section— (a) shall be taken to prejudice the operation of any rule of law restricting a director of a company from having any concern or interest in any contract or arrangement with the company; (b) shall apply to any contract or arrangement entered into or to be entered into between two companies where any of the directors of the one company or two or more of them together holds or hold not more than two per cent. of the paid-up share capital in the other company

Register of Directors and Key Managerial Personnel (Section 170)

(1) Every company shall keep at its registered office a register of its directors and key managerial personnel containing the following particulars, namely:-

   (a) Director Identification Number (optional for key managerial personnel);

   (b) present name and surname in full;

   (c) any former name or surname in full;

   (d) father's name, mother's name and spouse's name(if married) and surnames in full;

   (e) date of birth;

   (f) residential address (present as well as permanent);

   (g) nationality (including the nationality of origin, if different);

   (h) occupation;

(i) date of the board resolution in which the appointment was made;

(j) date of appointment and reappointment in the company;

(k) date of cessation of office and reasons therefor;

(l) office of director or key managerial personnel held or relinquished in any other body corporate;

(m) membership number of the Institute of Company Secretaries of India in case of Company Secretary, if applicable; and

(n) Permanent Account Number (mandatory for key managerial personnel if not having DIN);

(2) In addition to the details of the directors or key managerial personnel, the company shall also include in the aforesaid Register the details of securities held by them in the company, its holding company, subsidiaries, subsidiaries of the company's holding company and associate companies relating to-

(a) the number, description and nominal value of securities;

(b) the date of acquisition and the price or other consideration paid;

(c) date of disposal and price and other consideration received;

(d) cumulative balance and number of securities held after each transaction;

(e) mode of acquisition of securities ;

(f) mode of holding – physical or in dematerialized form; and

(g) whether securities have been pledged or any encumbrance has been created on the securities.

Register for Loan and Investment by Company (Section 186 (9) and (10):

Section 186 (9): Every company giving loan or giving a guarantee or providing security or making an acquisition under this section shall keep a register which shall contain such particulars and shall be maintained in such manner as may be prescribed.

Section 186 (10) The register referred to in sub-section (9) shall be kept at the registered office of the company and —

(a) shall be open to inspection at such office; and

(b) extracts may be taken therefrom by any member, and copies thereof may be furnished to any member of the company on payment of such fees as may be prescribed.

Register of Securities bought back (Section 68 (9)): Where a company buys back its shares or other specified securities under this section, it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.

Proper books of accounts (Section 128)

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(1) Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting:

Provided that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place: Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

(2) Where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (1), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarized returns periodically are sent by the branch office to the company at its registered office or the other place referred to in sub-section (1).

(3) The books of account and other books and papers maintained by the company within India shall be open for inspection at the registered office of the company or at such other place in India by any director during business hours, and in the case of financial information, if any, maintained outside the country, copies of such financial information shall be maintained and produced for inspection by any director subject to such conditions as may be prescribed: Provided that the inspection in respect of any subsidiary of the company shall be done only by the person authorised in this behalf by a resolution of the Board of Directors.

(5) The books of account of every company relating to a period of not less than eight financial years immediately preceding a financial year, or where the company had been in existence for a period less than eight years, in respect of all the preceding years together with the vouchers relevant to any entry in such books of account shall be kept in good order: Provided that where an investigation has been ordered in respect of the company under Chapter XIV, the Central Government may direct that the books of account may be kept for such longer period as it may deem fit.

8.4.1 Important Considerations

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It may be recalled here that an auditor has a duty to make a report specifying, among other things, whether proper books of account have been kept and whether the financial statements disclose a true and fair view and comply with the Companies Act. In doing so, the auditor needs to carry out a series of audit procedures. While carrying out such procedures, the auditor has to be on the lookout to ensure that the company has not violated any of the requirements of the Act. One such requirement is the maintenance of registers and books of account prescribed by the Act and detailed in the above paragraphs. In addition, these registers and books will enable him to carry out examinations to ascertain that the items mentioned therein comply with statutory requirements and generally accepted accounting principles. To take one example, Register of contracts with companies and firms in which the directors are interested enables the auditor to identify transactions of purchase or sale of goods in which any director is interested and to make sure that such transactions are entered into under proper sanction of the Board of directors.

Again, minute books are an important source of evidence concerning a number of matters which fall within the scrutiny of the auditor. Following are given a few examples of important matters which can be found in the minutes of the meetings of the Board of directors and which are of significance to the auditor:

1. Appointment and remuneration of the first auditors of the company or to fill a casual vacancy.
2. Approval of company's accounts and directors' report for submission to the members in general meeting and recommendation as to dividend.
3. Approval of transfer to reserves.
4. Approval of material items of capital expenditure and the declaration of any financial interest which any director may personally have in such expenditure.
5. Allotment and forfeiture of shares.
6. Allotment of debentures.
7. Appointment and conditions of service governing key officials of the company such as managing director, company secretary, etc.
8. Matters concerning registration of charges on the properties of the company.
9. Affixing the company's seal to transfer of shares and other documents.
10. Decisions concerning proposed interim dividend.
11. Approval of directors' fees , especially if based on attendances at Board meetings.
12. Appointment of bankers and officials authorised to sign cheques, bills, etc.
13. Resolutions concerning investments.

14. Matters which require the sanction of the Board of directors under the provisions of the articles of association.
15. Important decisions concerning the future policy of the company, etc.

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Some of the important matters in the minutes of the meetings of the members and which are of significance to the auditor are:

1. Appointment and remuneration of auditors.
2. Removal of auditors.
3. Adoption of annual accounts and declaration of dividends.
4. Appointment and remuneration of directors.
5. Matters concerning the accounts which require the approval of the meeting of members, etc.

Officials of the Company and Books Maintained by Them

Obtain a list of the officials of the company along with their specimen signature and names of the books and registers maintained by them. This will facilitate the clearance of queries which the auditor may have to make in the course of performing various audit procedures.

Examination of Basic Documents

(i) Certificate of incorporation: Where the audit is that of a newly incorporated company, the Certificate of Incorporation should be examined before commencing audit in order to make sure that the company has been duly incorporated.

(ii) Certificate to commence business: In the case of a public limited company, it is entitled to commence business only on obtaining the Certificate to Commence Business. As such this document should be examined by the auditor where the audit is concerned with the accounts of a newly started public limited company.

(iii) Memorandum of association: This important document should be examined by the auditor to ascertain the provisions concerning the accounts of the company and to ensure that the issued share capital is within the authorised share capital as specified in the memorandum. The 'Objects Clause' is also of special relevance to the auditor since any transaction in relation to activities outside the 'Objects Clause' will be *ultra vires* the company and the auditor has a duty to point out this in his report. Failure to report the same will make him liable for negligence.

(iv) Articles of association: Articles of association contain the internal regulations of the company and as such the auditor should be well acquainted with the provisions contained therein. It should be noted that where a company has not registered separate articles, the regulations contained in Table A of the Act shall apply. The observations made by the learned judge in Leeds Estate Building and Investment Co Ltd Vs Shepherd that "it was no excuse that the auditor had not seen the articles when he knew of their existence" may be recalled in this connection. Thus, failure on the part of the auditor to get familiarised with the provisions of the articles of association and to make sure that these provisions have been complied with by the management in carrying out its duties will make the auditor liable for negligence.

Few examples of important matters which are found in the articles of association and which would be of interest and significance to the auditor are as given below:

Provisions concerning -

1. Issue of share capital, rights attached to different classes of shares, variation of rights, minimum subscription, etc.
2. Payment of underwriting commission.
3. Lien on shares.
4. Calls on shares, calls in arrears and calls paid in advance.
5. Forfeiture of shares.
6. Transfer and transmission of shares.
7. Conversion of shares into stock.
8. Share warrants.
9. Reorganisation of share capital.
10. Dividends.
11. Reserves and capitalisation of profits.
12. General meetings and proceedings at general meetings.
13. Voting rights.
14. Directors, their remuneration, qualifications, disqualifications, removal, etc.
15. Meetings of the Board of directors and the proceedings thereat.
16. Borrowing powers of the company and the directors.
17. Appointment of managing director, manager, secretary, etc.
18. Common seal of the company.
19. Payment of interest out of capital.
20. Accounts and audit.

(v) Prospectus: Where a company has issued a prospectus, the matters referred to in the previous section under 'articles of association' will be matters of interest to the auditor. In addition, particulars will be there of any contract or arrangement whereby any option or preferential right is given to any person who subscribe for shares or debentures of the company; of any contract entered into with vendors for the purchase of any property, and the amount payable in cash, shares or debentures in respect of purchase consideration; of any goodwill payable; of the amount or estimated amount of preliminary expenses and of any material contracts entered into within two years of the date of issue of the prospectus. These are all matters of significance to the auditor.

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(vi) ***Contracts:*** The details of all contracts entered into by the company in relation to the acquisition of properties; payment of commission, brokerage and preliminary expenses and agreements which have a bearing on the accounts are all to be examined by the auditor.

(vii) ***Previous year's balance sheet, profit and loss account, directors' report, auditor's report and other related statements:*** Except in the case of the audit of a newly established company, the auditor should obtain copies of the previous year's Balance Sheet, Profit and Loss Account, directors' report, auditor's report and other related statements. Much valuable information will be forthcoming from these statements which would be of significance to the auditor in performing current year's audit procedures. The opening balances of the current year should be verified with the closing balances of the previous year's audited accounts. It should also be remembered that it is a Companies Act requirement that, except in the case of a newly established company, the corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet shall also be given in the balance sheet of any particular year. The requirement in this behalf shall, in the case of companies preparing quarterly or half yearly accounts, etc, relate to the balance sheet for the corresponding date in the previous year. The previous year's audit report is of interest and significance to the auditor in that it may give a glimpse of matters which are of vital importance to the auditor while carrying out the current year's audit procedures. Any qualification in such report should receive the careful consideration of the auditor. Even before commencing the current year's audit, the auditor should take note of the action taken by the company in dealing with the qualification and the remedial measures adopted. So also, the previous year's directors' report merits careful examination in order to get an idea about the overall picture concerning the working of the company including the relevant recommendations regarding appropriation of profits. An examination of the minute books of the relevant meeting of the members coupled with the action taken will make clear whether such recommendations were approved and carried out.

(viii) ***Letter of engagement:*** Although a letter of engagement is not an essential requirement in the case of limited company audits, since the scope and limits of the duties of an auditor are clearly specified in the Companies Act, it is advisable to define in writing the scope of the work which the auditor undertakes and other matters relevant to the audit. It gives the management of the company an insight into the work of the auditor, including that relating to the accounting and related internal control systems and to accounting records and the financial statements in general. In this connection, the reader's attention is invited to the Chapter "An Introduction to Basic Audit Work" where a detailed discussion on 'letter of engagement' is given.

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(ix) ***Accounting system and related internal controls:*** A written statement from the management of the company regarding the accounting system followed in the company together with a brief description of the internal controls instituted will act as a reminder to the management that the primary responsibility to instal a proper accounting system coupled with the relevant internal controls with a view to ensure a true and fair view of the financial statements rests with it.

Check Your Progress

3. Mention the registers to be maintained by companies as per Section 88(1).
4. List the matters not to be included in the minutes as per the Section 188.
5. Which section of the Companies Act mandates the preparation of 'proper books of accounts.'?

8.5 TYPES OF AUDIT REPORT

The opinion expressed in the audit report may be classified into:

- Unqualified Opinion
- Qualified Opinion
- Adverse Opinion
- Disclaimer of Opinion

1. Unqualified Opinion

An auditor issues an unqualified opinion when he is satisfied in all material respects with the following matters:

- Acceptable accounting policies have been used in the preparation of the financial statements.
- The accounting policies used in the preparation of the financial statements have been consistent.
- The financial statements comply with relevant regulations and statutory requirements.
- The view presented by the financial statements as a whole is consistent with the auditor's overall knowledge of the client business.
- All material matters relevant to the proper presentation of the financial statements have been adequately disclosed.

An unqualified opinion indicates implicitly that changes in accounting principles or in the method of their application and the effects thereof have been properly determined and disclosed in the financial statements.

2. Opinions other than Unqualified

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An auditor will not find it possible to express an unqualified opinion when he is not satisfied as to the various matters he is required to report under the Companies Act. These matters have already been highlighted. In addition, the auditor may conclude that the financial statement, although otherwise complying with the requirements of the Companies Act, fail to disclose a true and fair view and hence cannot express an unqualified opinion. A few examples of matters which may lead the auditor to such a conclusion are given below:

(a) In the auditor's opinion, the financial statements do not conform to accounting principles appropriate to the circumstances and nature of the business;

(b) The financial statements are prepared on principles inconsistent with those previously adopted and without adequate explanation of the effects of the change;

(c) The auditor is unable to agree with the amount at which an asset or liability is stated;

(d) The auditor is unable to agree with the amount at which an income or expenditure is stated;

(e) The auditor is unable to agree with the amount at which profit or loss is stated;

(f) The financial statements do not disclose information which, though not specifically detailed in the Act, is necessary for the presentation of a true and fair view;

(g) Additional information given in a note, or in the directors' report, materially alters the view otherwise given by the financial statements.

According to International Auditing Guidelines, an auditor may not be able to express an unqualified opinion when any of the following circumstances exists and, in the auditor's judgement, the effect of the matter is or may be fundamental to the financial statements, viz.,

(i) There is limitation in the scope of auditor's work;

(ii) The auditor disagrees with the management concerning the financial statements;

(iii) Significant uncertainty affecting the financial statements exists and the resolution of the uncertainty depends on future events.

The circumstances indicated in (i) and (ii) result in either a qualified opinion or a disclaimer of opinion and those indicated under (iii) result in either a qualified opinion or an adverse opinion.

Qualified Opinion

The auditor expresses a qualified opinion when he is of the view that it is not possible to issue an unqualified opinion but that the effect of limitation on scope or of disagreement or of uncertainty is not so material as to require an adverse opinion or disclaimer of opinion. Here the auditor will report that subject to specific reservations or with specific exceptions, the financial statements show a true and fair view.

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Adverse Opinion

The auditor expresses an adverse opinion when the effect of disagreement is so material that he concludes that a mere qualification of his report is not sufficient enough to bring out the misleading or incomplete nature of the financial statements. Here the auditor will report that in his opinion the financial statements do not show a true and fair view. Of course, a qualification in these terms will be made only in extreme cases.

Disclaimer of Opinion

The auditor expresses a disclaimer of opinion where the possible effect of a limitation on scope or of an uncertainty is so material and significant that he concludes that he is not in a position to form an opinion on the financial statements. Here, the auditor will report that he is unable to, and does not, form an opinion whether the financial statements show a true and fair view.

Guidelines on Expressing an Opinion Other than Unqualified

At the very outset it may be made clear that before giving a report other than unqualified, it would be advisable on the part of the auditor to discuss the points at issue with the client management. This might enable the management to examine these points and, so far as it is practicable and appropriate, to take steps to provide information which is lacking or to amend the financial statements in such a way that the auditor will find it possible to give an unqualified report.

In those cases where the auditor is constrained to express an opinion other than unqualified, it is important that he should include a clear description of all the substantive reasons which prompted him to express such an opinion and, wherever practicable, a quantification of the possible effects of the same on the financial statements. In this connection, the observations made by the Institute of Chartered Accountants in England and Wales are pertinent. According to these observations, if an opinion other than an unqualified one is called for, the auditor must decide:

(a) To which specific matters his reservations apply;

(b) Whether he actively disagrees, or on the other hand, lacks sufficient evidence to enable him to form an opinion as regards material items in the financial statements;

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

Again, a qualifying statement should be direct and informative. It should be so phrased as to leave the reader in no doubt as to its meaning or the view formed by the auditor or the implications for the financial statements. It should:

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(i) Be as brief as is consistent with clarity;

(ii) Be specific as to the items and facts, and as far as possible, the amounts involved;

(iii) Within the limits of information available to the auditor, make clear its effects on the accounts;

(iv) Express the auditor's opinion without giving a chance for misinterpretation.

The object should be to give in clear and unequivocal terms, so far as circumstances permit, such information in augmentation of that provided by the financial statements and notes thereof as will, in the opinion of the auditor, provide the information required by the Act and ensure that the financial statements will then give a true and fair view.

In conclusion, it may be observed that the auditor should never allow himself to heed to the request of the client's management to refrain from making certain specific comments in his report on the ground that the fact of doing so will be harmful to the interests of the members, and hence to indicate in general terms the point at issue. An auditor who allows himself to be persuaded to do so runs the serious risk of being held to have failed in discharging his duty to the shareholders. It would be enlightening to recall the observations made by the learned judge in the London and General Bank case:

> '.. A person whose duty it is to convey information does not discharge this duty by simply giving them so much information as is calculated to induce them or some of them to ask for more. Information and means of information are by no means equivalent terms... An auditor who gives the shareholders the means of information instead of information in respect of a company's financial position, does so at his peril, and runs the very serious risk of being judicially to have failed to discharge that duty ...'

Check Your Progress

6. What is an unqualified opinion in audit reports?
7. When does an auditor expresses a disclaimer of opinion?

8.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. As per Section 143 (9) of the Act: Every auditor shall comply with the auditing standards.

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2. Section 143 (15) says that If any auditor, cost accountant, or company secretary in practice does not comply with the provisions of sub-section (12) in reporting frauds, he shall,—
   (a) in case of a listed company, be liable to a penalty of five lakh rupees; and
   (b) in case of any other company, be liable to a penalty of one lakh rupees.
3. Section 88 (1) Every company shall keep and maintain the following registers in such form and in such manner as may be prescribed, namely:—
   (a) register of members indicating separately for each class of equity and preference shares held by each member residing in or outside India;
   (b) register of debenture-holders; and
   (c) register of any other security holders.
4. As per Section 118, (5): There shall not be included in the minutes, any matter which, in the opinion of the Chairman of the meeting,—
   (*a*) is or could reasonably be regarded as defamatory of any person; or
   (*b*) is irrelevant or immaterial to the proceedings; or
   (*c*) is detrimental to the interests of the company.
5. Section 128(1) of the Companies Act mandates the preparation of 'proper books of accounts.'
6. An unqualified opinion indicates implicitly that the changes in accounting principles or in the method their application and the effects thereof have been properly determined and disclosed in the financial statements.
7. The auditor expresses a disclaimer of opinion where the possible effect of a limitation on scope or of an uncertainty is so material and significant that he concludes that he is not in a position to form an opinion on the financial statements.

8.7 SUMMARY

- The following are the duties of the company auditor as per the Companies Act 2013: Duty to Prepare Audit Report, Duty to Report Matters, Duty to prepare Audit report for Government Company, Duty to follow Auditing Standards, and Duty to Report Frauds.
- The format of the audit reports depends upon the objective of the audit and its terms of engagement.
- An audit report should include the following basic elements: title, addressee, identification, reference to auditing standards, signature, address and date.
- A company registered under the Companies Act 2013 is required to maintain the following books: register of investments which are not held by the company

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in its own name, register of charges, register of members, index of members, index of beneficial owners, foreign register of members, debenture holders, other security holders or beneficial owners residing outside India , minutes of proceedings of general meeting, meeting of board of directors and other meeting and resolutions passed by postal ballot, registers of contracts, companies and firms in which directors are interested, register of directors and key managerial personnel and proper books of account.

- Basic documents that need to be examined by auditors include certificate of incorporation, certificate to commence business, memorandum of association, articles of association, prospectus, contracts, previous year's balance sheet, profit and loss account, director's report, auditor's report and other related statements; letter of engagement and accounting system and related internal controls.
- The opinions expressed in the audit report may be classified into unqualified opinion, qualified opinion, adverse opinion, and disclaimer of opinion.

8.8 KEY WORDS

- **Auditor's report:** A formal opinion or disclaimer issued by either an internal auditor or an independent external auditor.
- **Minutes of meeting:** It refers to the formal written record of the proceedings of a Meeting as mandated by the applicable law.
- **Letter of engagement:** It refers to the writing contract expressing the scope of work which the auditor undertakes and other matters relevant to the audit.

8.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Why is an auditor's report considered essential tool when reporting financial information to users, particularly in business?
2. Write a short note on the elements which should be contained in an audit report.
3. What does the Companies Act 2013 say about the register of charges?
4. Write a short note on the provisions related to register of members as per the Companies Act 2013.
5. Briefly mention the important matters which can be found in the minutes of meetings of Board of Directors and members.
6. List the conditions in which an auditor expresses an unqualified opinion.

Long Answer Questions

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1. Describe the duties of an auditor as per the Companies Act 2013.
2. Explain the key registers to be maintained in relation to Minutes of Proceedings of General Meeting, Meeting of Board of Directors and Other Meeting and Resolutions Passed by Postal Ballot (Section 118).
3. What should the register of directors and key managerial personnel contain as per the Companies Act 2013?
4. Describe provisions related to maintenance of proper books of accounts given in the Companies Act 2013.
5. Discuss examination of basic documents by an auditor.
6. Explain the types of audit reports expressing opinions other than unqualified and the guidelines for it.

8.10 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

Shekhar, L and K C Shekhar. 2003. *Auditing, 20th edition*. Delhi: Vikas Publishing House.

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BLOCK III
SHARE CAPITAL, BRANCH, COST AUDITS

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UNIT 9 AUDIT OF SHARE CAPITAL

Structure

9.0 Introduction
9.1 Objectives
9.2 Steps Involved in Issue of Shares: Verification of Allotment, Money Received and Calls
9.2.1 Alteration of Share Capital
9.3 Answers to Check Your Progress Questions
9.4 Summary
9.5 Key Words
9.6 Self Assessment Questions and Exercises
9.7 Further Readings

9.0 INTRODUCTION

In the previous unit, you had learnt about the concept of audit reports and the provisions related to the maintenance of books and accounts as per the Companies Act 2013. In this unit, we move to another important aspect of company audit: share capital and its audit. Companies require funds to run its operations, many times the funds required for such operations exceed the profits or revenue earned by the firm. Other times, there could be conditions like difficulty in securing investments from good sources or many other factors. In such cases, a good option for companies is to raise capital from the public in return offering them a share of the company. In this unit, you will learn about the concepts of steps involved in issue of shares and the audit steps involved in the verification of allotment, money received, calls and alteration of share capital.

9.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the process of issue of shares
- Explain the provisions of the Companies Act in relation to issue of shares
- Describe the audit objectives in case of audit of share capital
- Examine the audit procedure for verification of allotment, money received, money received, calls and alteration of share capital.

9.2 STEPS INVOLVED IN ISSUE OF SHARES: VERIFICATION OF ALLOTMENT, MONEY RECEIVED AND CALLS

The steps involved in the issue of shares are:

- **Issue of prospectus:** It contains all the necessary information related to the company detailing its vision, mission, operations, number and prices of shares to be issued, manner in which the money will be collected from investors, etc.
- **Issuing of applications:** In this step, the organizations issue application receipts to the investors who wish to purchase the share following the regulations as mentioned in the prospectus on the collection of amounts from them.
- **Allocation of shares:** This is the final step in the issue of shares, in which the shares are issued to the investors after the minimum subscription limits are met. A letter of allotment is shared with the investors at this step.

Let's now look at what the provisions of the Companies Act 2013 says about matters related to the issue of shares:

Document Containing Offer of Securities for Sale to be Deemed Prospectus

Section 25 (1) of the Companies Act 2013 says, 'Where a company allots or agrees to allot any securities of the company with a view to all or any of those securities being offered for sale to the public, any document by which the offer for sale to the public is made shall, for all purposes, be deemed to be a prospectus issued by the company; and all enactments and rules of law as to the contents of prospectus and as to liability in respect of mis-statements, in and omissions from, prospectus, or otherwise relating to prospectus, shall apply with the modifications specified in sub-sections (3) and (4) and shall have effect accordingly, as if the securities had been offered to the public for subscription and as if persons accepting the offer in respect of any securities were subscribers for those securities, but without prejudice to the liability, if any, of the persons by whom the offer is made in respect of mis-statements contained in the document or otherwise in respect thereof.'

Issue of Application Forms for Securities

As per Section 33 (1): No form of application for the purchase of any of the securities of a company shall be issued unless such form is accompanied by an abridged prospectus:

Provided that nothing in this sub-section shall apply if it is shown that the form of application was issued-

(a) in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to such securities; or

(b) in relation to securities which were not offered to the public.

(2) A copy of the prospectus shall, on a request being made by any person before the closing of the subscription list and the offer, be furnished to him.

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(3) If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default.

Allotment of Securities by Company

As per Section 39:

(1) No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.

(2) The amount payable on application on every security shall not be less than five per cent of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf.

(3) If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.

(4) Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed.

(5) In case of any default under sub-section (3) or sub-section (4), the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

Securities to be Dealt with in Stock Exchanges

As per Section 40:

(1) Every company making public offer shall, before making such offer, make an application to one or more recognised stock exchange or exchanges and obtain permission for the securities to be dealt with in such stock exchange or exchanges.

(2) Where a prospectus states that an application under sub-section (1) has been made, such prospectus shall also state the name or names of the stock exchange in which the securities shall be dealt with.

(3) All monies received on application from the public for subscription to the securities shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than-

(a) for adjustment against allotment of securities where the securities have been permitted to be dealt with in the stock exchange or stock exchanges specified in the prospectus; or

(b) for the repayment of monies within the time specified by the Securities and Exchange Board, received from applicants in pursuance of the prospectus, where the company is for any other reason unable to allot securities.

(4) Any condition purporting to require or bind any applicant for securities to waive compliance with any of the requirements of this section shall be void.

(5) If a default is made in complying with the provisions of this section, the company shall be punishable with a fine which shall not be less than five lakh rupees but which may extend to fifty lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees.

(6) A company may pay commission to any person in connection with the subscription to its securities subject to such conditions as may be prescribed.

Audit Objectives

Before learning about the audit steps to be taken in case of issue of shares, let's discuss the audit objectives concerning the verification of share capital.

The audit objectives concerning the verification of share capital in financial statements are to ascertain whether:

(i) Share capital at the end of the year is properly recorded;

(ii) Changes in share capital during the year are included in the accounts properly;

(iii) Changes in the authorized or issued capital have been carried out under proper authorization such as properly authorized resolution of the members and/or board of directors;

(iv) The relevant provisions relating to share capital contained in the articles and memorandum of association of the company as well as the relevant statutory provisions (i.e., the Companies Act requirements) have been complied with;

(v) The record of shareholders maintained by the company is proper and accurate; and all issues, transfers, etc. relating to shares during the current period have been appropriately entered in the records.

It would be advisable for the auditor to obtain a schedule from the client showing in summarized form the authorized and issued share capital as at the end of the year, classifying the same by class of shares and containing such relevant particulars as –

(a) Changes effected in the authorized and issued share capital together with are conciliation showing the figures at the end of the financial period with the figures as at the end of the previous financial period;

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(b) Calls in arrear and calls received in advance;

(c) The amounts and dates of redemption of any redeemable preference shares;

(d) Where cumulative preference dividends are in arrears, the amounts concerned and the period for which they have remained in arrears.

In case the schedule as above is not forthcoming from the client, the auditor will have to prepare it himself. Even when the schedule is received from the client, the auditor is expected to ensure that the calculations on the schedule are correct. He should also check the reconciliation of the figures of authorized and issued share capital as at the beginning and close of the financial period and should compare them with the relevant figures in the financial statements.

The auditor should tally the description and the amount of authorized capital in the schedule with those in the articles and memorandum of association of the company. Any changes in the authorized or issued share capital should be verified by reference to the prospectus (or, equivalent document), the allotment book/ sheets and the board minutes and the minutes of the general meeting.

Audit Procedures in Relation to Issue of Shares

During the first year after the incorporation of the company, the auditor will have to carry out detailed audit procedures in connection with the issue of shares. Given below is a list of audit procedures to be performed in this connection:

1. Make sure that the provisions contained in the articles and memorandum of association of the company coupled with the prospectus or equivalent document (e.g., statement in lieu of prospectus) have been complied with.
2. Make sure that the allotment was made only after the amount of minimum subscription as stated in the prospectus (or, equivalent document) has been subscribed, and the sum payable on application for the amount so stated has been paid to and received by the company in cash or by cheque or other instrument. Also, see that the amounts received from the applicants for shares are deposited in a scheduled bank until the certificate to commence business is obtained or where such certificate has already been obtained, until the entire amount of minimum subscription has been received.
3. See that the amount payable on application on each share is not less than five per cent of the nominal value of the share.
4. Ensure that, before offering shares for public subscription, the company had made an application to one or more recognized stock exchanges for permission for the shares to be dealt in on such stock exchange or exchanges. Also, ensure that all amounts received from applicants were kept in a separate bank account maintained with a scheduled bank until the permission as above had been granted or until the disposal of an appeal against the refusal to grant such permission. Further, ensure that the amount standing to

the credit of such bank account was utilized only for adjustment against allotment of shares (Refer to Section 40 of the Act).

5. Ascertain whether permission has been obtained from the Controller of Capital Issues for the allotment of shares, wherever such permission is necessary.
6. In case the company has paid any brokerage or underwriting commission, see that this is in conformity with the provisions contained in Section 40 of the Act, that the articles of the company authorize such payment and that it is disclosed in the prospectus. Underwriting commission paid should be verified by reference to the underwriting contracts and receipts given by the underwriters. Ensure that the rate of commission paid does not exceed that authorized by the articles of the company or, five per cent of the price at which the shares are issued, whichever is less and that it agrees with the amount disclosed in the prospectus. Brokerage paid should be verified by reference to the stamps of brokers on application forms.
7. In case the company has entered into preliminary contracts, see that they are in accordance with the terms contained in the prospectus.
8. Ensure that the nominal value of the shares allotted is within the limits of the authorized and issued share capital and that allotments are in accordance with the provisions contained in the prospectus.
9. Verify the amounts received on application of shares by checking the entries in the Application and Allotment Book with the original applications together with the entries in the cash book and bank records and make sure that the money so received was deposited in a scheduled bank to comply with the requirements of Section 39 of the Act. Amount refunded to unsuccessful applicants should be vouched by reference to the copies of letters of regret, cash book and bank records (e.g., bank passbook/bank statements). Check the journal entry debiting Share Application Account and crediting Share Capital Account and ensure the accuracy of the amount by reference to the Application and Allotment Book.
10. Check board minutes to see that the allotment of shares has been properly approved. Check entries in the Application and Allotment Book by reference to copies of letters of allotment. Verify the amount received on allotment of shares by checking the entries in the cash book. Ascertain the total amount payable on allotment. Check the journal entry debiting Share Allotment Account and crediting Share Capital Account and ensure the accuracy of the amount by reference to the Application and Allotment Book. Make sure that the return of allotment was filed with the Registrar of Joint Stock Companies within thirty days of the allotment (Refer to Section 39).
11. In case calls have been made on shares, check the board minutes to see that such calls have been made on the basis of a properly approved resolution. Verify the amounts received in respect of the calls by reference to the

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counterfoils of the receipts. Check the Calls Book for calls due and the cash book for cash received and verify the entries in the Share Register. Check the journal entry debiting the Call Account and crediting Share Capital Account. Ascertain the total amount payable on calls and see whether calls in arrears have been arrived at correctly. Calls in arrears should be shown separately in the financial statements. See whether the company has received any calls in advance and, if so, whether the articles of the company allow such a procedure. Make sure that such calls in advance are also shown separately and that they are not shown as part of capital. Verify calls in advance by reference to the cash book, bank passbook/bank statements and counterfoils of receipts issued.

12. Where shares have been issued for consideration other than cash, examine the underlying contract in respect of which such shares have been issued and the board minutes to see that the issue has been authorized through a proper resolution. Also, ensure that the relevant contracts were produced to the Registrar of Joint Stock Companies for inspection and examination, and copies of such contracts and a return stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up and the consideration for which they have been allotted have been filed with the Registrar (Refer to Section 39). Further, make sure that such shares are shown separately in the financial statements.

Shares Issued at a Premium—Audit Steps

1. Ensure that premia received on shares are transferred to “the securities premium account”.
2. Ensure that the ‘securities premium account’ is not utilised for any purpose other than as provided in section 52 of the Act, namely, :
   (a) in paying up unissued shares of the company to be issued to members as fully paid bonus shares;
   (b) in writing off the preliminary expenses of the company;
   (c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or
   (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.
3. Vouch the amount of premia received.

Shares Issued at a Discount—Audit Steps

1. Ensure that the provisions of section 53 of the Act have been complied with where shares are issued at a discount, namely, :
   (a) the shares at a discount are of a class already issued;
   (b) the issue is authorised by the company in general meeting and sanctioned by the Company Law Board;

(c) the resolution specifies the maximum rate of discount which should not normally exceed ten per cent;

(d) at the date of issue, not less than one year has elapsed since the date on which the company was entitled to commence business; and

(e) the issue is made within two months of the sanction of the Company Law Board or within such extended time as the Company Law Board has allowed.

2. Make sure that the prospectus relating to the issue contained particulars of discount allowed on the issue of the shares or of so much of that discount not written off at the date of the issue of the prospectus.

3. Ascertain whether the amount of discount is shown separately in the financial statements under the head “Miscellaneous expenditure” until the same is written off.

9.2.1 Alteration of Share Capital

Section 61 of the Companies Act 2013, discusses the provisions related to the Power of Limited Company to Alter its Share Capital:

(1) A limited company having a share capital may, if so authorised by its articles, alter its memorandum in its general meeting to-

(a) increase its authorised share capital by such amount as it thinks expedient;

(b) consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares:

Provided that no consolidation and division which results in changes in the voting percentage of shareholders shall take effect unless it is approved by the Tribunal on an application made in the prescribed manner;

(c) convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;

(d) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the memorandum, so, however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

(e) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

(2) The cancellation of shares under sub-section (1) shall not be deemed to be a reduction of share capital.

Notice to be Given to Registrar for Alteration of Share Capital

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The Companies Act 2013 through Section 64 says that:

(1) Where-

(a) a company alters its share capital in any manner specified in sub-section (1) of section 61;

(b) an order made by the Government under sub-section (4) read with sub-section (6) of section 62 has the effect of increasing authorised capital of a company; or

(c) a company redeems any redeemable preference shares, the company shall file a notice in the prescribed form with the Registrar within a period of thirty days of such alteration or increase or redemption, as the case may be, along with an altered memorandum.

(2) Where any company fails to comply with the provisions of sub-section (1), such company and every officer who is in default shall be liable to a penalty of five hundred rupees for each day during which such default continues, subject to a maximum of five lakh rupees in case of a company and one lakh rupees in case of an officer who is in default.

Alteration of Share—Audit Steps

1. Examine the articles of association of the company to ensure that they contain the necessary provision as regards alteration of share capital.
2. Check the minutes of the general meeting to confirm that the alteration of share capital has been authorised through a proper resolution.
3. Make sure that the procedures prescribed by the articles of association in relation to alteration of share capital have been complied with.
4. Ensure that notice has been given to the Registrar of Joint Stock Companies specifying the required information.
5. Check the Board minutes concerning the resolution dealing with allotment, consolidation, conversion or subdivision of the shares.
6. Examine the cancelled share certificates, where applicable, and agree the same with the counterfoils of the new share certificates issued.
7. Ensure that the share capital account is correctly shown in the financial statements.

Check Your Progress

1. Which company document is used by an auditor to tally the description and amount of authorized capital in the schedule?
2. What is the primary condition for allotment of any securities of a company?
3. How is the amount refunded to unsuccessful applicants vouched?
4. How is the authorization of alteration of share capital confirmed?

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9.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The auditor tallies the description and the amount of authorized capital in the schedule with those in the articles and memorandum of association of the company.
2. As per Companies Act 2013, the following is the primary condition for allotment of any securities: No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.
3. Amount refunded to unsuccessful applicants are vouched by reference to the copies of letters of regret, cash book and bank records (e.g., bank passbook/bank statements).
4. The auditors use the minutes of the general meeting to confirm that the alteration of share capital has been authorised through a proper resolution.

9.4 SUMMARY

- The steps involved in the issue of shares are issue of prospectus, issuing of applications, and allocation of shares.
- The audit objectives covering the verification of share capital in financial statements are to ascertain proper record of share capital at the end of the year, changes in share capital, changes in authorised capital, compliance with statutory provisions, accurate and proper records.
- During the first year after the incorporation of the company, the auditor will have to carry out detailed audit procedures in connection with the issue of shares.
- Section 61 of the Companies Act 2013, discusses the provisions related to the Power of Limited Company to Alter its Share Capital.
- The audit steps in case of alteration of share capital include examining of articles of association, minutes of the general meeting, compliance with procedures prescribed by the articles of association, notice given to the Registrar, checking of board minutes, cancelled share certificates and checking correct reflection of share capital account in the financial statements.

95 KEY WORDS

- **Share:** It means a share in the share capital of a company and includes stock.

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- **Authorised capital:** Also known as nominal capital, it means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company.
- **Allotment:** It refers to the creation and allocation of new shares by a company.
- **Call on shares:** It refers to the notice sent by the director of the company to the shareholders asking them to pay up partially or fully (as specified) the unpaid amount on the shares they hold.

9.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the steps involved in the issue of shares?
2. Briefly discuss the provisions related to the issue of share capital in the Companies Act 2013.
3. How are the allotment and calls on issue of shares audited?
4. Write a short note on the ways in which share capital can be altered as per the provisions of the Companies Act 2013.
5. Mention the audit steps in case of alteration of share capital.

Long Answer Questions

1. Discuss the objectives in case of audit of share capital.
2. Explain audit steps in case of issue of shares at premium and discount.
3. Describe the audit procedures in relation to issues of shares.

9.7 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

Shekhar, L and K C Shekhar. 2003. *Auditing, 20th edition*. Delhi: Vikas Publishing House.

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UNIT 10 BRANCH, SPECIAL JOINT, CONTINUOUS, STATUTORY AND MANAGEMENT AUDITS

Structure

10.0 Introduction
10.1 Objectives
10.2 Branch and Statutory Audit: Objectives, Scope, Advantages and Disadvantages
10.3 Special Audit: Objectives, Scope and Advantages
10.4 Joint Audits: Advantages and Disadvantages
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10.7 Answers to Check Your Progress Questions
10.8 Summary
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10.0 INTRODUCTION

Now that you have learnt about company audits and audit of share capital, in this unit, we move towards other different categories of audit. Auditing is very useful for organizations in detecting errors and frauds and ensuring that its functioning is as per the regulated law, rules, regulations and accounting principles of the reasons. These are crucial for the development of the organization by ensuring efficiency in its operations. There can be many different reasons for conducting an audit or the type of audit to be adopted. Companies should weigh in the pros and cons of the different auditing methods and adopt one suitable to its operations, and funds available. In this unit, you will learn about branch, statutory, special, joint, continuous and management audits.

10.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the concept of branch and statutory audits
- Describe the types and objectives of special audits

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- Explain the concept of joint audits
- Examine the advantages and disadvantages of continuous audit
- Assess the development, objectives and advantages of management audit

10.2 BRANCH AND STATUTORY AUDIT: OBJECTIVES, SCOPE, ADVANTAGES AND DISADVANTAGES

Companies Act 2013 makes it mandatory for specified organizations to conduct audit. These types of audits which are mandated by law are called statutory audits. As per Section 139(1) : 'Subject to the provisions of this Chapter, every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting and the manner and procedure of selection of auditors by the members of the company at such meeting shall be such as may be prescribed:

Provided that the company shall place the matter relating to such appointment for ratification by members at every annual general meeting:

Provided further that before such appointment is made, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be in accordance with the conditions as may be prescribed, shall be obtained from the auditor.'

You have already learnt the previous units, the different aspects of statutory audits. The basic scope of such audits is that:

- It is a legal requirement.
- It reports on the financial statements of a company.
- It is performed by an auditor appointed at the annual general meeting.
- It is checks for the compliance with financial reporting standards as operational in the country.
- The statutory auditor is responsible to the company's shareholders.

Advantages of Statutory Audits:

- Helps improve credibility of the organization
- Useful for gaining trust of investors, bankers and government
- Assist in improving the management
- Useful for authenticating the financial reports
- Critical for minimizing errors and frauds
- Assists in improving internal control functions

Disadvantages of Statutory Audits:

- Is a costly affair
- Punishment for contravention of laws found are heavy and serious
- There may be disruption of work when the audit procedure is in process
- All documents may not be checked in case of sampling and thereby total assurance is not guaranteed

Branch Audits

Since we are on the subject of statutory audits, it will be crucial to mention a sub-division of such audits. Organizations can be small or large scale. In case of large-scale corporations, companies might have expanded their business in other areas by opening branches. Branch audit simply refers to the audit of branches of a company.

As per Section 2(14) of the Companies Act 2013: 'Branch office, in relation to a company, means any establishment described as such by the company.'

Books of Accounts to be kept by Company

Section 128 of the Companies Act 2013 provides the following provisions in relation to the book of accounts to be maintained by branch offices:

(*1*) Every company shall prepare and keep at its registered office books of account and other relevant books and papers and financial statement for every financial year which give a true and fair view of the state of the affairs of the company, including that of its branch office or offices, if any, and explain the transactions effected both at the registered office and its branches and such books shall be kept on accrual basis and according to the double entry system of accounting:

Provided that all or any of the books of account aforesaid and other relevant papers may be kept at such other place in India as the Board of Directors may decide and where such a decision is taken, the company shall, within seven days thereof, file with the Registrar a notice in writing giving the full address of that other place:

Provided further that the company may keep such books of account or other relevant papers in electronic mode in such manner as may be prescribed.

(*2*) Where a company has a branch office in India or outside India, it shall be deemed to have complied with the provisions of sub-section (*1*), if proper books of account relating to the transactions effected at the branch office are kept at that office and proper summarised returns periodically are sent by the branch office to the company at its registered office or the other place referred to in sub-section (*1*).

Sub-section 8 of Section 143 of the Companies Act 2013 says that ' Where a company has a branch office, the accounts of that office shall be audited either

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by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.'

Duties and Powers of the Company's Auditor with Reference to the Audit of the Branch and the Branch Auditor

(1) For the purposes of sub-section (8) of section 143, the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be as contained in sub-sections (1) to (4) of section 143.

This is the same as the duties of the Auditors as discussed in Unit 8.

(2) The branch auditor shall submit his report to the company's auditor.

(3) The provisions of sub-section (12) of section 143 read with rule 12 hereunder regarding reporting of fraud by the auditor shall also extend to such branch auditor to the extent it relates to the concerned branch.

The scope of branch audits is similar to that of statutory audits with respect to the duties and powers of the auditor.

Advantages and Disadvantages of Branch Audit:

It helps companies in maintaining proper and authenticated books of accounts for each branch. It helps in gaining the trust of the investors, banks and government which may help in case the company wants to invest more in the particular branch of operations. It assists companies in recognizing the management efficiency of different branches and figure out branches which are lacking. This will help them in bringing improvement or adopting good aspects of one branch at another branch. It helps companies in increasing the accountability of the branches to push them towards working more efficiently. In case of any adverse report in the audits, the image of the entire company will not be affected.

The disadvantage of branch audits is that it is a costly affair. It may result in intense competition amongst the branches. This may lead to fight for funds which will come at the cost of smaller branches.

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10.3 SPECIAL AUDIT: OBJECTIVES, SCOPE AND ADVANTAGES

Special audit is a special kind of audit which may be initiated by the government or internally by the organization regarding certain specific area of functioning. There are many types of special audits and their scope and objectives can be understood as follows:

- Tax audit: These are conducted to verify and analyse the tax returns of the company and to see that appropriate taxation rules have been followed and obligations fulfilled.
- Compliance audit: These are audits done to check whether the company is following the correct and mandated accounting principles and procedures in their operations. Deviances from principles of the issued accounting standards are revealed in such audits.
- Investigative audit: These are audits specially authorized to find out details related to specific events or transactions or projects where the company and its members are concerned as to the occurrence of fraudulent activities.
- Information systems audit: These are special audits to check the efficiency of the controls systems related to the information systems of the organization and their contribution to the management objectives.
- Construction audits: These audits are undertaken specially to verify the costs and investments done for specific projects.

It is crucial to mention here that special audits are generally called when there are suspicions of abnormal activities or overlooking of principles and standards in the organizations. In fact, such a provision was present in the Companies Act 1956, section 233A under Power Of Central Government To Direct Special Audit In Certain Cases:

(1) Where the Central Government is of the opinion-

(a) that the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or

(b) that any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(c) that the financial position of any company is such as to endanger its solvency; the Central Government may at any time by order direct that a special audit of the company' s accounts for such period or periods as may be specified in the order, shall be conducted and may by the same or a different order appoint either a chartered accountant as defined in clause (b) of sub- section (1) of section 2 of the Chartered Accountants Act. 1949 (38 of 1949 .) (whether or not such chartered

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accountant is a chartered accountant in practice within the meaning of that Act), or the company' s auditor himself to conduct such special audit.

But this provision does not find a mention in the Companies Act 2013.

Advantages of Special Audits

- It helps in figuring out any abnormal activities in the organization
- It assists companies in ensuring that the processes and functioning of the companies are as per the laws.
- It helps companies identify weak areas.

10.4 JOINT AUDITS: ADVANTAGES AND DISADVANTAGES

The term joint audits may be understood from two different perspectives:

- Appointment of more than one auditor for a single firm
- Clubbing of different audit areas in a single audit

In this section, we will learn about the concept of joint audits in the context of the former perspective.

Many times, large entities decide to appoint not just one but more than one auditor for auditing the books of accounts. In such type of audits, the auditors work together to report on their observations about the financial statements of the company. The ICAI has provided its opinion on joint audits in the Statements on the Responsibilities of Joint Auditors' (Revised SA 299).

To understand the concept of Joint Audit, the following four aspects must be understood:

- In respect of understanding the areas of responsibility, the auditors should mutually agree on whether to take responsibility for specific units, identifiable locations or divisions.
- There should be co-ordination between the joint auditors whether it comes to sharing relevant audit information amongst themselves when the need arises and maintain healthy communication.
- Although joint auditors are responsible for the work assigned or mutually decided by them, they are jointly and severally responsible for work not divided and carried out by all; decisions jointly taken by all, presentation and disclosure of information, compliance with relevant standards, bringing to the knowledge of other auditors critical audit information of relevance to all.

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- Joint auditors generally present a single report after agreement but there may be instances where auditors with different opinions present different reports.

Advantages of Joint Audits

- Quality of information which is presented in the audit report will be very well informed given that multiple auditors are working together for a single audit.
- The efficiency of the auditing procedure will increase with useful division of work.
- Multiple perspective involved in joint audits will help in bringing out the best suggestions and observations.

Disadvantages of Joint Audits

- Since multiple auditors are involved, there are increased costs
- Difference of opinion and approaches may delay and make the audit process more complicated.
- The litigation process may become more complicated as it will be difficult to pinpoint liability on a single auditor.
- Discord between auditors may hamper the quality of work being done.

Check Your Progress

1. Which section of the Companies Act mandates the auditing of branch accounts of companies?
2. Who does the branch auditor submit his report to?
3. Which now defunct section of the Companies Act 1956 mentioned provisions related to special audits?
4. Mention the standard issued by ICAI on responsibilities of joint auditors.

10.5 CONTINUOUS AUDIT: OBJECTIVES, ADVANTAGES AND DISADVANTAGES

In the case of a continuous audit, work of audit is carried out throughout the accounting period by the audit staff engaged continuously on the audit.

The objective of undertaking a continuous audit is to put in place a system in which regular triggers or alarms may be sounded as and when errors or unusual activities are identified in the system. This will help the companies ensure that the problems are taken up when they occur so that damages are minimized, and corrections made as soon as possible. This will not only improve the efficiency of the system but also save a lot of costs. Continuous audits also allow the companies to effectively assess its activities in real time and see the progress of feedbacks being incorporated in the system. The scope of continuous audit can be decided on the basis of scale of operations, division of work, funds available and nature or activities of an organization. The type of industry also is a critical factor in deciding whether continuous auditing is beneficial or not.

Advantages

- Since the audit staff are engaged in the work continuously, fraud and errors are detected sufficiently early with the result that the amount of defalcations, irregularities and errors will be less than would be the case otherwise.
- It is possible to carry out a more detailed checking. Such detailed checking reveals more about the functioning or malfunctioning of the client's system of accounting and related internal controls.
- The work of audit assistants can be arranged more effectively, giving due consideration to the pressure of work in different client organisations.
- It acts as a moral check on client staff in that they will give particular importance to keep the work upto date because of the frequent visits by the auditor.
- Continuous engagement on the work enables the auditor to understand better the technical details of the client organisation.
- Since most of the detailed checking will be over by the end of the accounting period, it facilitates the completion of final work more quickly with the result that the final accounts can be presented without much delay after the end of the financial year.
- Because of the constant contact which the audit staff have with the work, audit programmes can be reviewed according to the developing circumstances.
- Wherever possible and feasible, closer cooperation and coordination of work between the external auditor and internal auditor can be achieved.

Disadvantages

- There are possibilities of the client staff altering the figures either innocently or fraudulently once the auditor has completed checking a part of the work.
- Periodical checking of the books and records may cause inconvenience to the client staff through interruption of their work.
- Similarly, attendance by audit staff at intervals may lead to their failure to follow up unfinished work during the previous visit.
- Audit staff will find it necessary to maintain detailed notes on accounts and balances, especially in respect of unfinished work during any visit.

- There is the danger that the audit staff might lose the impartiality of outlook when they are allowed to remain on a continuous audit over a long period of time because of the possibility that they tend to regard themselves as a part of client staff.
- It is an expensive system of audit.

In spite of the above disadvantages, big business organisations generally prefer continuous audit. This is all the more so in the case of organisations which require their final accounts to be presented immediately after the end of the accounting period.

Certain precautions may be taken to overcome most of the disadvantages mentioned above. The client staff should be given strict instructions that no alteration, however, genuine it may be, should be made once the auditor has examined the books and records and that, if necessary, rectification of an error should be made only through an adjusting entry. The auditor should use special ticks while passing altered figures. When ticking an altered figure, the amount should be inserted in ink in small figures to prevent any misunderstanding as to the figure which has been accepted. Similarly, client staff should be instructed to enter periodical totals in ink or in any other permanent form to guard against alteration.

Inconvenience to the client staff can be avoided to a great extent through a judicious selection of work completed up to a particular date.

Proper follow up by the audit staff can be ensured through extensive note taking, properly planned audit programmes and proper supervision. The audit working papers should include:

- Notes of important totals taken from the books of account up to the stage to which they have been checked
- Details of any alterations that have been made in figures checked earlier
- Details of transactions which appear to be unusual or exceptional and which therefore call for special treatment
- Notes of any verification tests carried out
- Particulars of errors discovered

The audit programme should be so drafted as to show clearly:

- Work to be done during the course of each quarter or month
- Work to be performed at the final stages

10.6 MANAGEMENT AUDIT: SCOPE, OBJECTIVES, ADVANTAGES AND DISADVANTAGES

Management audit helps in the evaluation of the effectiveness and suitability of an organization with the help of rules, procedures and methods. If the management audit is performed in the right manner in the organization then it helps the organization in achieving its goals and objectives. When performing management audit in an organization, the auditors must follow four basic rules. These rules are:

- **Serve your Customers**: Auditors serve three basic types of customers, which are the auditee, the client and the organization. One of the main goals of the auditor is to pass the audit. However, before passing the audits, the auditor must try to know whether the organization on which the audit is being performed is performing efficiently or not. In this case, an external auditor's perspective can be quite valuable. In the end, auditors must also serve the needs of the organization. The auditor can only assist the organization by determining whether the organization is working in the right manner in order to achieve its goals.
- **Use Qualified People**: Auditors must possess certain skills and qualities so as to perform their jobs efficiently. Auditors in order to perform their jobs efficiently need certain emotional, intellectual and mechanical skills, which they can obtain by attending appropriate courses, reading books or observing others. In addition to conducting an audit, auditors must be familiar with the technical processes that are being used for the process of audit in the organization. Auditors must also be able to communicate well, both orally and in writing.
- **Measure against Agreed Criteria**: The auditor must not make his own rules while performing the process of auditing in the organization. The auditor, in order to measure the performance of the organization, must use the national and international standards such as QS-9000 and ISO 9001. One of the main challenges of the auditor is to obtain and become familiar with the many levels of requirements forming the basis for the audit.
- **Use Facts to Form Conclusions**: Auditing is based on facts. These facts are the data that are drawn from the conclusions. An auditor must take into account all these facts while preparing the audit report. The auditor is an individual who assesses the efficiency of the management of the organization during management audit. The auditor also examines whether the plans and decisions taken by management have contributed to the achievement of organizational goals.

Definitions of Management Audit

There is no definite meaning of the term, management audit. However, management experts have provided certain definitions of management audit. According to T.G Rose, 'Management Audit would concern itself with the whole field of activities of the concern from top to bottom, starting as always, where management control is concerned, from top, because we are primarily concerned with where the general management is functioning smoothly and satisfactorily.' William P. Leonard says 'Management Audit may be defined as a comprehensive and constructive examination of an organization structure of a company, institution or branch of

Government, or of any component thereof, such as a division of department, and its plans and objectives, its means of operation and its use of human and physical facilities.'

In his book *Trends in Management Audit*, Campfield has defined management audit as 'an informed and constructive analysis, evaluation and series of recommendations regarding the broad spectrum of plans, process, people and problems of an economic entity'.

In the *Accountant's Journal*, management audit has been defined thus:

> Management Audit is a term synonymous to operations audit. It is a technique by which management can assess how effectively the executives and managers of the company plan, organise, direct, and control the use of men, money, materials, machinery, equipment and facilities to achieve corporate goals … A technique for regularly and systematically appraising a unit striving for functional effectiveness against corporate and industry standards by utilising personnel who are not specialists in the area of study. The ultimate objective is to assure the management that its aims are being effectively carried out and/or conditions that require improvement are identified.

Leslie Howard in his book *Principles of Auditing* says that

> Management Audit may be more specifically defined as being an investigation of a business from the highest level downwards in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with the outside world and the most efficient organization and smooth running internally.

Burton in his book *Management Audit*, describes management audit as an 'impartial evaluation of management performance beyond that implicitly provided by historical results'.

In the 1966 publication of *Accountancy Journal*, Churchil and Cyert said, 'Management Audit is performed with the object of examining the efficacy of the information control system, management and management procedures towards the achievement of enterprise goals'.

P. Chattopadhya in his book *External Management: A Rejoinder* says,

> Management Audit …… would require scrutiny of both structural and functional aspects of an organization … the former providing the framework in which functions take shape. Unless one goes into the policies guiding actions of management and bringing forth different types of results, performance assessment can be best partial.

Thus, management audit is basically an appraisal of the structure of an organization and the way in which it is organized. The appraisal in management audit is done by a group of experts and the main objective of this audit is to identify problems instead of solving them. In management audit, one of the functions, is to identify the areas where improvement is required. Management audit examines the existing objectives of an organization. It also assesses the policies, which are followed in the organization for the fulfilment of its objectives. One of the tasks of management audit is to determine whether or not the policies are correctly followed in the organization.

E.H Morse has made the following observation with regard to management audit,

> '(T)he term financial auditing itself can properly embrace all that is contemplated by those who adopt the term management auditing.' This observation has been made by Morse based on the argument that 'all activities and operations of an organization have financial aspects'.

The concept of management audit is not well developed and is still in its growing stages. However, organizations all over the world have accepted management audit as an important process that needs to be followed routinely.

Development of Management Audit

There are various factors that have contributed to the development of management audit. These factors are:

- **Size, Scale and Complexity of Business Operations**: The size, scale and complexity of business operations have grown because of organizations' desire to search for and manufacture new products. The increasing size and scale of business operations has resulted in making the business activities complex. After a period of time, the expansion of business becomes difficult and unmanageable. In order to manage complexity in business operations, techniques such as Budgetary Control and Standard Control, Value Analysis and Operational Research have been adopted by organizations. Management audit has also been used by organizations to manage the human limitations of top management.
- **Need to Improve Productivity**: In order to achieve industrial development, organizations are trying to improve their productivity through economical utilization of resources such as national, human and capital. It is difficult to measure some resources while other resources can be easily measured. In the same way, it is also difficult to measure the efficiency of management. In addition, the results achieved through improvement in efficiency of management are difficult to estimate. Through management audit, an organization tries to improve the productivity of management, which is an important and indispensable part.
- **Granting Financial Subsidy**: The granting of financial subsidy to financially weak organizations by the government or financial institutions is not sufficient unless the causes, which made an organization financially weak, are removed. It is necessary to identify problems such as corporate planning deficiencies, structural defects in an organization and ineffective management control system to make an organization strong. To identify these problems, management audit is required. Various unidentified problems will keep on occurring if financial subsidy is granted without management audit.

- **Take-over Bids**: A business organization can bid to take over another business organization. Similarly, government may also take steps to take over a business organization, which is weak. When taking over a business organization, the government or another business organization must keep in mind the following factors:
  - **Financial Aspects**: The financial aspects that should be kept in mind while taking over an organization include sales, growth, profitability, accounts, receivables/payables and retained earnings.
  - **Technical Aspects**: The technical aspects that should be considered while taking over a business organization include product attributes such as quality, image, productivity and technology.
  - **Management Aspects**: The management aspects that should be considered while taking over a business organization include competent personnel and management practices on labour management. The management aspects must be considered to understand the strengths, weaknesses and capabilities of the organization.

Management audit helps in determining the strengths, weaknesses and capabilities of an organization during take-over.

- **Societal Need**: A business organization must function keeping in mind the needs of the society. It must not operate only to provide profit to the entrepreneur who owns the organization. It is in the interest of all social groups such as consumers, government and employees that an organization functions properly and runs in an efficient manner. The social groups have to be provided assurance by the organization that its top and middle management are working efficiently in the interest of these groups. A regular management audit in the organization can give such assurance.
- **Need for Periodical Check-up**: Management audit should be performed periodically. Problems such as defects in the organizational structure, poor leadership, internal friction and inability to make decisions may not be easily identified through statutory audits. Thus, the need for periodic management audit arises. The various problems that are faced by a management include:
  - Poor performance of a department.
  - Suspicion that a report on an important problem in an operational area is not in detail.
  - The need to determine areas in which cost savings and efficiency analysis will provide positive results.
  - A new business is set up or another business is taken over.
- **Foreign Collaboration**: During collaboration with foreign companies, the foreign companies may want that a management audit of the units of the organization, with which it is collaborating, must be conducted. This will assure that funds provided by foreign companies are invested in proper

growth and expansion of the organization with which the foreign company is collaborating.

- **Equity Participation**: Financial institutions such as the Life Insurance of India (LIC), Unit Trust of India (UTI) and Indian Finance Corporation (IFC) participate in equity share capital of different organizations. These financial institutions may want the organizations in which they participate to conduct management audit so that these organizations do not suffer losses because of inefficient management.

Objectives of Management Audit

There are some objectives for which management audit is carried out in organizations. These objectives are:

- Management audit must be done to appraise the management functioning at all levels in an organization.
- Management audit must be performed to identify the decisions and activities of management that have not contributed to the fulfillment of organizational goals.
- Through management audit, the objectives of the organization must be fully understood by individuals working at different levels in the organization.
- Management audit must help in ensuring that effective controls are provided to the management functioning at different levels so that the objectives set for the management are fulfilled and the operational plans are successfully implemented.
- Management audit must help in examining the plans, which are the future activities to be performed for the fulfillment of organizational goals.
- Management audit must assess the organizational structure. This means that management audit must examine how responsibilities are distributed in the organization.

Advantages of Management Audit

The various advantages of management audit are:

- Management audit helps in collecting data such as accounting and economic data, which is needed by management of an organization for developing a policy framework.
- Management audit is useful in setting up a planning system. It also helps in assessing and enhancing the planning system.
- Management audit helps in setting up a system for establishing the objectives of the organization.
- Management audit helps to ensure that management of an organization gets the right information for making correct decisions.

- Management audit helps in determining whether or not management is using the information in an effective manner.
- Management audit is useful in designing and maintaining an efficient authority structure.
- Management audit helps in enhancing the management information system in the organization so that appropriate information can be provided to appropriate persons in management.
- Management audit is also useful in establishing an effective communication system.
- Management audit allows management of the organization to identify the key functions which will help in achieving profits.
- Management audit helps management of the organization in determining an effective criterion for measuring results.
- Management audit can be useful in avoiding wasteful utilization of resources in the organization.

Disadvantages of Management Audits

- It is still a largely vague concept which does not concretely defined.
- It may disturb the management processes and works.
- The scope of management audit is not specifically defined.
- There are no clear set of principles and practices which are to be followed in case of management audit.
- It is a subject type of audit and the success or failure of the process is highly dependent on the skills, experience and knowledge of the auditors.
- Many consider management audits as a waste of time and duplication of efforts since the critical matters are already reported by other types of audits like cost, financial and efficiency audits.
- Management audit may also result in discouragement of initiative among managers as they may fear that they may be criticized or scrutinized heavily for dynamic decisions taken later on.

Check Your Progress

5. What should be kept in mind while checking altered figures in continuous audits?
6. What are the aspects of take-over bids which are analysed with the help of management audits?
7. List some of the defects which are not identified through statutory audits which may be revealed by periodic management audit.

10.7 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. Sub-section 8 of Section 143 of the Companies Act 2013 mandates the auditing of branch accounts.
2. As per the Companies Act 2013, the branch auditor shall submit his report to the company's auditor.
3. The provision related to special audits was present in the Companies Act 1956, section 233A under Power Of Central Government To Direct Special Audit In Certain Cases.
4. The ICAI has provided its opinion on joint audits in the Statements on the Responsibilities of Joint Auditors' (Revised SA 299).
5. While checking altered figures in continuous audits, the auditor should make sure to use special ticks while passing altered figures. When ticking an altered figure, the amount should be inserted in ink in small figures to prevent any misunderstanding as to the figure which has been accepted.
6. The financial, technical and management aspects of take-over bids are analysed with the help of management audits.
7. Problems such as defects in the organizational structure, poor leadership, internal friction and inability to make decisions may not be easily identified through statutory audits. There may be taken care of by periodic management audit.

10.8 SUMMARY

- Companies Act 2013 makes it mandatory for specified organizations to conduct audit. These types of audits which are mandated by law are called statutory audits.
- The basic scope of statutory audits is that: It is a legal requirement, it reports on the financial statements of a company, it is performed by an auditor appointed at the annual general meeting, it is checks for the compliance with financial reporting standards as operational in the country and the statutory auditor is responsible to the company's shareholders.
- In case of large-scale corporations, companies might have expanded their business in other areas by opening branches. Branch audit simply refers to the audit of branches of a company.
- As per Section 2(14) of the Companies Act 2013: 'Branch office, in relation to a company, means any establishment described as such by the company.'
- Section 128 of the Companies Act 2013 provides the following provisions in relation to the book of accounts to be maintained by branch offices.

- Sub-section 8 of Section 143 of the Companies Act 2013 says that ' Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act…'
- Special audit is a special kind of audit which may be initiated by the government or internally by the organization regarding certain specific area of functioning.
- It is crucial to mention here that special audits are generally called when there are suspicions of abnormal activities or overlooking of principles and standards in the organizations. In fact, such a provision was present in the Companies Act 1956, section 233A under Power Of Central Government To Direct Special Audit In Certain Cases. But this provision does not find a mention in the Companies Act 2013.
- The term joint audits may be understood from two different perspectives: Appointment of more than one auditor for a single firm or Clubbing of different audit areas in a single audit.
- In such type of audits, the auditors work together to report on their observations about the financial statements of the company.
- In the case of continuous audit, the work of audit is carried out throughout the accounting period by the audit staff engaged continuously on the audit.
- Big business organizations generally prefer continuous audit. This is all the more so in the case of organizations which require their final accounts to be presented immediately after the end of the accounting period.
- Management audit helps in the evaluation of the effectiveness and suitability of an organization with the help of rules, procedures and methods. If the management audit is performed in the right manner in the organization then it helps the organization in achieving its goals and objectives.

10.9 KEY WORDS

- **Branch audit:** It refers to the audit of the operations of specific branch of an organization.
- **Special audit:** It refers to those audits which are limited to certain specific area of the activities of a company
- **Joint audits:** It refers to the practice of appointing more than one auditor for the auditing of a company.
- **Continuous audit:** It refers to the type of audit in which the work of audit is carried out throughout the accounting period by the audit staff engaged continuously on the audit.
- **Management audit:** It refers to the appraisal of the structure of an organization and the way in which it is organized.

10.10 SELF ASSESSMENT QUESTIONS AND EXERCISES

NOTES

Short Answer Questions

1. What is branch audit? What are its advantages and disadvantages?
2. Briefly explain the concept of joint audits.
3. Write a short note on the objectives of continuous audit.
4. What are the precautions that may be taken to overcome most of the disadvantages of continuous audit?
5. List the basic rules to be followed while performing management audit.
6. What are the objectives of management audit?

Long Answer Questions

1. Examine the types, objectives, and advantages of special audits.
2. Explain the advantages and disadvantages of continuous audit.
3. Describe the development of management audit.
4. Discuss the advantages and disadvantages of management audits.

10.9 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

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UNIT 11 COST AND EDP AUDITING

Structure

11.0 Introduction
11.1 Objectives
11.2 Cost Audit
11.2.1 Appointment and Powers of Cost Auditor
11.2.2 Cost Audit Report
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11.5 Summary
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11.8 Further Readings

11.0 INTRODUCTION

According to the Institute of Cost and Works Accountants of India (ICWAI) 'Cost audit is an audit of efficiency, of minute details of expenditure while the work is in progress.' Cost audit is primarily a precautionary measure, a model for the managerial policies and decisions and a gauge to measure the organizational performance. This unit deals with the appointment of the cost auditor, the conditions required for the appointment of the cost auditor, the functions, duties and responsibilities of the cost auditor as well as the role of the cost auditor. A cost auditor performs the role of both an auditor and a consultant. He aids the top management in financial planning, performance evaluation and in establishing coordination between departments. The cost auditor of the company has to prepare a cost audit report after completing the audit of cost accounts. It must be sent to the company law board and to the board of directors of the company. The report must be precise, concise and clear in presenting the facts to the authorities concerned. The report of the cost auditor would be a basis for decision-making for the top management. Hence, the cost auditor must go through the relative facts and scrutinize them again to determine whether the criticism or comments made by him are based on true facts.

In this unit, you will also learn about the administrative and procedural controls involved in Electronic Data Processing auditing and auditing with computers.

11.1 OBJECTIVES

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After going through this unit, you will be able to:

- Discuss the objectives of cost audit
- Explain the appointment of cost auditor
- Describe the powers of cost auditor
- Explain the approach to EDP and computerized auditing
- Discuss the administrative and procedural control in EDP auditing

11.2 COST AUDIT

The Institute of Cost and Works Accountants of India (ICWAI) describes cost audit as 'an audit of efficiency, of minute details of expenditures while the work is in progress and not a post mortem examination'. Cost audit is mainly preventive measure, a guide for management policy and decision, in addition to being a barometer of performance. Thus, cost audit has the following objectives:

- **Verifying and checking the cost accounts and records of an undertaking:** The important objective of the cost audit is to verify the cost records of the company. This will help the management to know the suitability of costing system.
- **Detecting errors and frauds or malpractices:** The cost audit will detect the errors in the accounts, it also identifies any of the frauds committed by accountants and any malpractices adopted if any malpractices are traced out in cost audit. Hence, the management can take corrective measures to prevent such things in the future.
- **Identifying the deficiencies in the cost accounts:** One of the important objectives of the cost audit is to find out any deficiency in the system of cost accounting. Cost audit will explore any lapses which are taking place in the cost accounting system of an undertaking.
- **Checking how far the present procedure of cost accounting is helpful to the management for decision-making:** The main function of the management is decision-making. Cost audit will examine know how far it is useful for decision-making.
- **Protecting the interest of the stakeholders:** There are many stakeholders involved in the corporate world, such as management, consumers, employees, government, financial institutions and society (public). The objective of cost audit at this juncture is to protect their interest by examining and certifying that the cost records are in accordance with the standards.

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- **Determining the deficiencies in use of cost components like materials, labour and overheads etc.:** The cost audit objective at this point is to scrutinize the present system of deploying resources and to suggest any improved measures to increase the productivity as well as profitability. The competitive environment poses many challenges to the companies to utilize the resources efficiently.
- **Ensuring that the cost accounting records are drawn properly:** It is one of the important objectives of cost audit. Cost auditor has to ensure that the cost records are prepared in accordance with the standards specified. He has to certify that no violation of standards has taken place in the cost records. If any violation has taken place then it is the duty of the cost auditor to point out the same and report to the authorities (management or government).
- **Examining whether the expenditure incurred has been wisely incurred or not:** Cost audit aids in the examination and helps in judging the genuineness of the expenditure incurred. Here, at this point the cost auditor has to judge whether reasonable amount spent or any wastages have taken place. If any wastage expenditure is found, the cost auditor has to bring it to the knowledge of the management.
- **Exploring the possibilities of reducing costs and earning more profits:** Cost audit provides the guidelines to reduce the costs to the greatest possible extent. The profitability of the undertakings also can be improved by cost audit.
- **Assessing the physical and financial gaps between needs and resources available:** The cost audit should be able to provide the information regarding the funds required, and the other resources required for efficient production.

Difference between Cost Audit and Financial Audit

There are several differences between cost audit and financial audit. Though the procedure is the same, there are differences in the approach and methods of auditing. Table 11.1 lists the difference between the two:

Table 11.1 *Differentiation between Cost Audit and Financial Audit*

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Cost Audit	Financial Audit
The scope of Cost audit is wider compared to financial audit.	The scope of financial audit is limited to the verification of financial statements.
Cost audit is not compulsory for all types of companies.	Financial audit is compulsory for all types of companies.
Cost audit has forward looking approach.	The financial audit is historical in nature.
The main object of cost audit is to analyse and justify each element of cost of the product, process or an activity.	The main object of financial audit is to see whether proper records of accounts are maintained and to ensure that income statement and balance sheet reveal true and fair view of the affairs of the company.
Generally, the cost audit will take place in the factory premises and during the work-in- progress.	The financial audit will take place after the preparation of accounts in the office premises but not in the factory premises.
In India, cost accountants are authorized to audit the cost accounts. Chartered accountants are also eligible.	In India, only chartered accountants will act as the auditors to audit the financial reports.
The cost auditor reports to the management in general and if the audit is ordered by the government under Sec – 148, the cost auditor will submit the audit report to the Company Law Board.	In general, the auditor will report to the shareholders. The auditor acts as the watchdog of the shareholders.
Cost audit measures the efficiency of the management. It will point out the decision-making ability of the management. If any faults are found it will guide the management to take preventive measures.	Financial audit measures the truthfulness of the accounts.
The cost auditor is appointed by the Board of Directors or Central Government.	Financial auditor is appointed by the shareholders in the general body meeting.

11.2.1 Appointment and Powers of Cost Auditor

The term 'cost auditor' pertains to an auditor directed to conduct an audit under clause (28) of Section 2 of the Companies Act, 2013. The cost auditor is an auditor who verifies the cost accounts and checks the adherence to the costing plan. He covers propriety audit and efficiency audit. He is appointed by the board of directors of the organization in accordance with the procedure as laid in the Companies Act, 2013. The cost auditor plays a pivotal role in the successful operation of the company.

The company (Amendment) Act 1965, had introduced two new sections, i.e., Section 209 clause (d) and Section 233 (B) pertaining to cost audit in the then Companies Act, 1956. According to sections the Central Government acquires powers to cost audit in cases of those companies that are engaged in production, processing or mining activities, etc. However, all companies that are engaged in these activities are not subject to cost audit but only those which may be specifically ordered by the Central Government.

Further, an audit conducted by a cost auditor shall be in addition to the audit conducted by an auditor under the Companies Act. It should however be noted that a cost audit is to be conducted only if the Central Government makes an order for a particular year and for a specified company. As soon as the orders of the Central Government are notified directing the company to have a cost audit conducted, the board of directors either through a resolution passed in the meeting or by circulation appoints a cost auditor subject to the approval of the Central Government.

Note: The section 209 and the section 233, introduced by the company (amendment) Act 1965, are section 129 and section 148 in companies act 2013.

The Central Government has prescribed rules regarding the maintenance of cost accounting records separately for many industries like cycles, caustic soda, cement, electric pumps, refrigerators, tyres, aluminium, vanaspathi, sugar, etc. A careful study of the prescribed rules by the cost auditor is recommended before the cost audit is conducted.

Appointment of Cost Auditor

According to the section 148 of the Companies Act 2013, a cost auditor shall be appointed by the board of directors of the company in accordance with the provisions of section 139 also imposes ceiling on the number of audits that an auditor or firm of auditors can undertake.

On receipt of the order of the Central Government, directing the company to have a cost audit conducted, the board of directors passes a resolution either at a meeting or through a circulation appointing a cost auditor, subject to the appeal of the Centre. Normally, the concurrence of the cost audit is obtained prior to passing the resolution, after which the approval of the Central Government is sought (in form 23C). The Central Government communicates approval to both the company and the proposed cost auditor. A formal letter of appointment is then issued to the cost auditor by the company.

If the cost audit is initiated by other than the Central Government the above mentioned procedure need not be followed. A qualified cost auditor may be appointed for the purpose of the conduct of the cost audit.

The appointment of the cost auditor is specified by the same rules as applicable for a statutory auditor discussed in Unit 7.

To sum up, the following rules and regulations are to be followed for the appointment of the cost auditor:

- **Board of directors:** The cost auditor has to be appointed by the board of directors under section 148 of the Companies Act. The board of directors are authorized to appoint the cost auditor as per Section 148 of the Companies Act, 2013. A majority of the companies follow this method of appointing cost auditors.
- **Company law board:** The prior approval of the company law board is essential for appointing the cost auditor. This will be done on receipt of specific orders from the company law board for auditing the cost accounting records of a particular year for specified products.

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- **Resolution:** For the appointment of the cost auditor, the board of directors is required to pass a resolution either in its meeting or by circulation with a condition that the same is subject to approval by the Central Government.
- **Consent**: The consent of the cost auditor is essential before appointing the cost auditor. Further, the cost auditor has to inform the appointing authority about his acceptance. The cost auditor is required to inform to the management about his willingness to audit the cost records.
- **Prescribed form:** After acquiring the consent of the cost auditor, the management is required to send an application in a prescribed form CRA 2 (Companies Act 2013) as illustrated at the end of this unit, which is then submitted to the central government with the prescribed fee along with a copy of the board's resolution.
- **Acceptance:** After receiving the letter of appointment, the cost auditor should communicate with the previous auditor, if any. He must send his formal acceptance of the assignment to the company. The appointment procedure concludes with the acceptance letter of the cost auditor.
- **Ceiling:** The appointment of cost auditor is valid for the year for which he is appointed. The Central Government has recently permitted the cost auditor's appointment for two terms. The application for the re-appointment or change of auditors may be made only after the expiry of the two terms. The cost auditor is expected to carry out his work by applying reasonable skill, care and competence. He must act independently, detached and impersonal while discharging his duties as a cost auditor.

Qualifications required for a cost auditor

According to the Companies Act, 2013, the following persons are eligible to be appointed as the cost auditor under section 148.

- A cost accountant within the meaning of the Cost and Works Accountants Act, 1959 or
- Any such chartered accountant within the meaning of the Chartered Accountants Act, 1949 and who has passed Part I of the Management Accountancy Examination of the Institute of Chartered Accountants of India, or
- Other person, as may posses the prescribed qualification

Disqualifications of a cost auditor

The qualifications or disqualifications prescribed for the appointment of the statutory auditor under section 141 are also applicable for the appointment of the cost auditor. You have already learnt the same under statutory auditor in Unit 7. The disqualifications of the cost auditor are detailed as follows:

(i) A body corporate, an officer or employee of the company, or a partner or employee of an officer or employee of the company cannot be appointed as its cost auditor.

(ii) Similarly, a person who is indebted to the company or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding as may be prescribed is also disqualified.

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(iii) Further, a person who holds any voting shares of the company cannot be appointed as its cost auditor.

(iv) Also, a person cannot be appointed as the cost auditor of a company, if he is disqualified to be the cost auditor of its subsidiary or holding company, or of another subsidiary of its holding company.

(v) A person appointed under section 139 of the Companies Act as an auditor of a company cannot be appointed or re-appointed for conducting the audit of cost accounts of that company.

(vi) In addition to the above, the Institute of Cost and Works Accountants of India (ICWAI) has notified that any cost accountant who accepts an appointment of a company in the following situations shall be deemed to be guilty of professional misconduct.

(vii) If he is a partner or employee of the company's auditor appointed under section 139 of the Company's Act, 2013.

(viii) If he is an employee of any of the partners of a firm of chartered accountant which is appointed as the Company's auditor under section 139 as aforesaid.

Functions of Statutory Cost Auditor (Cost Audit Programme)

The cost auditor has to keep in mind the following factors while the cost audit programme is undertaken by him:

(i) The objectives of the cost audit programme

(ii) The organizational details of cost accounting system employed

(iii) The desirability of internal control system in operation

(iv) The managerial decisions taken and the alternatives available

These four factors help the cost auditor in the proper arrangement and distribution of the audit functions to various members of the cost audit team.

The Institute of Cost and Works Accountants of India has clearly described the functions of the cost auditor in the cost audit programme. The various functions of a cost auditor are as follows:

- **Inventory:** With regard to inventory, the cost auditor has to discharge a number of functions, such as coverage of shortage and carrying costs in optimum order size, valuation of inventory, supervision of materials, stores and supplies procurement and issues, supervision of expenditure on consumable stores, etc. The cost auditor has to provide particular information on the inventory valuation system for raw materials, for work-in-progress and for finished products in respect of the product under reference.

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- **Opening and closing stocks:** The cost auditor has to ensure that the opening stock is not unduly large, represents actual physical quantity and the records are properly maintained for all types of stock. With regard to closing stock, he has to ensure that physical verification of stock is properly carried out, the valuation of stock is correctly carried out and the volume of unmoved stock is identified.
- **Stores issue procedures:** The cost auditor has to ensure that the stock issues are properly authorized and the procedure is scientific. There should not be any possibility of loss or pilferage of stocks lying for production. Surplus materials and scraps in production should be returned to stores and their movements should be properly authorized and documented.
- **Work-in-progress:** Work-in-progress commonly exists in all organizations. With regard to work-in-progress, the cost auditor has to ensure that the work-in-progress is physically verified and recorded correctly. The work-in-progress should not be overvalued or undervalued. The cost auditor has to valuate the work-in-progress reasonably.
- **Labour (wages and salaries):** The cost auditor has to present the information of total wages and salaries concerning all categories of employees, individually based on direct labour cost on production; indirect employee costs on production; employee costs on administration; employee costs on selling and distribution; other employee costs, if any (specifying purpose); total employee costs. The cost auditor also needs to assess the performance of labour for which he has to compare actual performance with standard performance. He should examine the size of the labour force as well as ensure that the labour costs are properly allocated to different jobs.
- **Capacity utilization:** The cost auditor has to ensure that idle capacities are not excessive in any workshops. Machines, manpower and other resources must be used to the fullest extent. Excessive idle capacities must be avoided. The cost auditor is required to analyse capacity utilization with the help of various tools. Capacity utilization plays a significant role in improving productivity. The idle capacity should be reduced to possible extent. The cost auditor has to look into the capacities of various resources and make an analysis of their usage levels.
- **Overheads:** Overheads are the indirect costs that may occur; the cost auditor has to carefully manage the apportionment of overheads. The cost auditor has to provide separate accounts of the total amounts of overheads for the company and factory as well as the product under reference, including factory overheads, administration overheads, selling overheads, distribution overheads, etc. The cost auditor is required to portray the basis followed for allocation and apportionment of the common overheads like head office expenses to the product, capital works and other activities of the company. He is also required to ensure that all the manufacturing, administration and selling and distribution overheads are properly allocated to jobs or cost centres. The allocation should not result

in over-absorption and under-absorption of overheads. The cost auditor has to provide a brief analysis of the changes, if any, made in the costing system, method of overhead allocation, apportionment, etc., during the current financial year in comparison to the previous financial year.

- **Power and fuel:** The cost auditor has to present information about the quantity, rate per unit and total cost concerning each major form of power and fuel utilized in production, such as coal, furnace oil, electricity (separately for purchased and generated) and other utilities separately. The cost auditor is also required to provide a comparison of the actual physical consumption per unit of production of the product under reference with standards/budgeted if any and with the preceding two years consumption, and highlight any discrepancies.
- **Abnormal non-recurring costs:** Any aberrant circumstances influencing production during the year, including strikes, serious accidents, substantial power problems, lock outs, major break downs in the plant, etc., shall be mentioned in the cost audit report.
- **Depreciation:** The cost auditor should ensure the proper maintenance of cost records which must disclose information on the original cost of each asset, date of purchase, additions during the year, rate of depreciation, total amount of depreciation charged for the each asset. The rate of depreciation charged should be in accordance with the provisions of section 123 of the Companies Act. He must ensure that the rate of depreciation is consistently followed and any variations in the rates should be explained by the management. The method of calculating depreciations and the basis of allocation of depreciation on common assets to different departments must be stated.

Apart from these, functions the cost auditor may have to organize further enquiries to make the audit programme more authentic and reliable.

Rights of a Cost Auditor

A cost auditor has the same rights in relation to an audit conducted by him under section 148 as an auditor of a company under section 143. The following are his rights:

(i) **Right of access to books of accounts:** The cost auditor has a right of access to the books of accounts and vouchers of the company at all times. He can ask for the submission of any of the documents supporting the transaction. It is the duty of the staff to present the required information to the cost auditor.

(ii) **Right to get information:** The cost auditor has a right to get such information and explanations from the officers of the company as he may think necessary for the performance of his duties as an auditor. The auditor is entitled to seek any information from the accountants.

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(iii) **Right to get required facilities:** The cost auditor has a right to get all facilities and assistance from the company to perform his duties as an auditor. It is the duty of the company to provide all facilities for the smooth conducting of the audit.

(iv) **Right to punish:** The company and every officer, in default of not providing the accounts, vouchers, information, explanations, etc., to the auditor, shall be punishable with a fine. In such cases, the auditor also holds the authority to report these incidents to the management.

Duties of a Cost Auditor

The duties and responsibilities of the cost auditor have not been clearly stated in the Companies Act, 2013. The duties of the cost auditor are similar to that of the financial auditor as discussed in Unit 8. The following are some of the important duties and responsibilities of the cost auditor:

- **Audit report**: The main duty of the auditor is to prepare the audit report and to submit it to the company/Government. The cost auditor has to examine the cost accounting records and prepare a cost audit report according to the prescribed form. It is the primary responsibility of the cost auditor to prepare and submit the cost audit report. The cost auditor has to send his report to the Central Government and to the company within 180 (one hundred and eighty) days from the end of the company's financial year to which the cost audit report relates.
- **Examining the records**: In order to make the audit report, the auditor has to examine the relevant accounts as well as records and express his opinion on them. The cost auditor has to verify various documents and reports to determine the reliability of the accounts. All the records, such as materials, labour and overheads, etc., should be verified by the auditor. Further, the auditor needs to examine all the information pertaining to materials.
- **Conducting inquiry:** Section 143 specifies that the cost auditor has to inquire into certain relevant maters and report thereon if he is not satisfied with the results of his enquiry. Whenever the available information is not sufficient the auditor has to conduct inquiries to find out the truth. For this purpose the auditor can call the related parties for detailed inquiry.
- **Verification:** The cost auditor has to verify the cost accounts and related documents, invoices, vouchers, etc. All the related invoices and documents should be verified. The cost auditor has to verify the accounts and records of materials, labour and overheads and other related information to analyse the reliability of cost accounts.
- **Comparing accounting system:** The auditor has to compare the existing cost accounting of the undertaking with the standard system. This gives the facility to improve the system facilitating the company to adopt the best practices.

- **Maintaining secrecy:** The cost auditor is required to maintain secrecy of information regarding the concerns of company, or else it may pose a threat to the company's strategic information that may be lost.
- **Using information:** The auditor should not use any information for his personal benefit. The cost auditor is liable for the information and should not use any information of the company for his or for any other purposes. He is responsible for safeguarding the integrity of the company.
- **Responsible for faulty activities or any malpractices**: The cost auditor will be held responsible for any faulty activities or any malpractices. He should be very careful while discharging his duties. The cost auditor cannot avoid his responsibility with regard to the cost audit report. The report should contain all the required information as prescribed by the Companies Act. The cost auditor is responsible for the information which is provided in the cost audit report. If any default is made by the cost auditor, he is held accountable for it.
- **Responsible to all those parties who were misleading by his audit reports:** The cost auditor is held responsible to all those parties who were misled by his audit reports. If any party either investors or creditors or any other stakeholders are misled by the cost audit report, the cost auditor is held responsible for the parties. If any default is made by the cost auditor in complying with the provisions the cost auditor shall be punishable with fine as may be prescribed.
- **Answerable to all those who require clarifications regarding the audit report**: The cost auditor is responsible to clarify any doubts or clarifications, if any required. The cost auditor is required to give explanation's wherever necessary.

Role of a Cost auditor

In the present competitive business environment the role of the cost auditor is very significant. By virtue of the functions of the cost auditor one can understand the role of the cost auditor. A majority of business decisions are determined by the cost audit report. The cost auditor is very important with all regards. The role of the cost auditor is very important in all domains of the organization, including materials, labour, overheads, cost accounting system, etc. Due to growing liberalization, privatization and globalization of the economy, the entire business environment is undergoing a rapid transformation. In this context, the role of the cost auditor is gaining increasing significance. The cost auditor is like an expert consultant; he provides many useful insights to the company aimed at improving organizational efficiency and productivity. The cost auditor provides important information about the existing costing system and the required changes. The cost auditor plays a prominent role in controlling and reducing the cost of production. Further, the cost auditor provides suitable methods for calculating the amounts of depreciation, closing stock and opening stock. The reliability of the cost records markedly improve with cost audits.

11.2.2 Cost Audit Report

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Cost audit notes refers to a record which contains information on the significant facts discovered by the cost auditor in the audit, important clarifications sought, clarifications given by the concerned parties, his satisfaction or dissatisfaction on such clarifications, defects in the system of internal control frauds, manipulations, misappropriations, etc. The notes become a vital record for preparing the cost audit report. The cost auditor maintains precise notes on all significant observations made by him in the course of the cost audit programme. The cost audit notes aid the cost auditor in conducting his work, the preparation of the cost audit report, and in defending himself subsequently against an allegation, if made any, that he failed to discharge his duties with due skill, care and diligence. Thus, the cost audit notes are a vital record for the cost auditor. In the process of preparing the report, he should not hesitate to mention in the report if the management is at fault which has caused loss to the company or the cost of production has risen. However, the cost auditor must examine the relative facts and verify once before a final report is prepared.

Meaning and Definition of Cost Audit Report

Under Section 148 of the Companies Act the cost auditor has to submit his report to the Central Government in the prescribed form and simultaneously send a copy of the report to the company. The company has to furnish to the central government full information and explanations on every aspect contained in the cost audit report within 30 days from the date of receipt of the copy of the report. After considering the report and the information and explanations furnished by the company on the cost auditors reservations or qualifications, the central government can also call for further information and explanations from the company to be furnished within a specified time. Thus, the cost audit report is a significant document for the company.

Definition: A report is a form of communication and a medium of information. It is an attention directing device furnishing essential facts of the functional areas of an organization. In a more specific way, it is a written form of communication representing the condensation of detailed information taken from records and other sources. A cost report constitutes all the elements of a report except that it is always presented in financial terms. It primarily presents feedback information. Emanating from a specialist branch of accounting, cost report necessarily conveys figures about costs, revenues, profits, investments and restated matters in actual budgeted and standard costs.

Cost audit report refers to cost reports which communicate usually in a written form, of physical or cost facts which should be brought to the attention of the management personnel who can use them to take appropriate action.

Objectives of a Cost Audit Report

Reporting is an important technique of generating information. The main objectives of a report are as follows:

(i) The primary objective of a cost audit report is to provide desired information to management, in a comprehensive and functional form. The essential facts of the functional areas of production and distribution identified in the cost accounting systems should be thoroughly analysed.

(ii) The secondary objective of reports is the control over operations of business. This is a significant objective, and securing action on reports is an indication of the management's anxiety to make the attainment conform to the plans.

Preparation of a Cost Audit Report

The cost auditor while preparing the cost audit report has to keep in mind the following guidelines:

- The idle capacities of machines and men should be identified and examined.
- The huge stocks of unutilized raw materials held in the stores should be traced and an explanation regarding the same should be sought for, since it locks up the working capital of the company.
- The maintenance of cost records is adequate for the purpose of cost audit but they should be regularly verified.
- It must be examined whether the policies and programmes declared by the company are strictly adhered to. If any deviations are found, the reasons for such deviations should be identified.
- The cost auditor must give more weightage to the cost of production, comparative profitability and operating efficiency of different product lines of the company.
- The changes in the cost of production should be identified and the reasons for the same must be analysed.
- The report should also contain information on any wastage in the process of production, and remedies for avoiding such wastage should be offered.
- The report should also contain the areas in which the cost of production is controlled or minimized.
- The report must reveal a true and fair view of the cost of production.
- The cost audit report must be sent to the Central Government and to the company within 180 days from the end of the company's financial year to which the report relates.
- If there are two units manufacturing the product for which the cost audit has been ordered, a separate cost audit report is required to be submitted for each unit.

- The cost audit report contains (i) normal audit assertions, (ii) the cost auditor's observations and suggestions, (iii) the annexure containing specified information, including various costs margins, etc.

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- The auditor should thoroughly examine whether the report has covered all the necessary information and explanations and proper cost accounting records as per the requirements of the Companies Act.
- The cost auditor is required to provide helpful inputs and provide important observations and suggestions.
- The annexure should contain figures for the year under audit and for the two preceding years in the case of financial position.

Major Contents of Cost Audit Report Rules

The major contents of the cost audit report are as follows:

- **General information**

  (i) Name and address of the registered office of the company whose accounts are audited

  (ii) Name and address of the cost auditor

  (iii) Reference number and date of the Government letter approving the appointment of the cost auditor

  (iv) Date and reference number of Government order under which the audit is conducted

  (v) Factory location

  (vi) The company's financial year for which the audit report is rendered

  (vii) Date of the first commencement of commercial production of the product under reference

  (viii) Information concerning the other activities of the company, if any, besides the manufacture of the product under reference and a brief note on the nature of such activities.

  (ix) A copy of the annual report, i.e., audited profit and loss account and balance sheet in respect to the company's financial year for which the report is rendered enclosed with the cost audit report.

- **Cost accounting methods**

  (i) Explaining the cost accounting system in the company in keeping with the requirements of the cost accounting records rules applicable to the class of manufacturing companies under reference and also its adequacy

  (ii) Providing specific interpretation on the inventory valuation system followed for raw materials, work-in-progress and for finished products in respect of the product

(iii) If any changes are introduced in the costing system, methods of overhead apportionment, allocation, etc, they are deemed as changes during the current financial year as compared to the previous financial year.

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• **Financial position**

To present the financial items in the balance sheet and to know the financial position of the firm the following items are covered in the cost audit report.

Capital employed: The capital employed is defined as an average of fixed assets at net book value (excluding intangible assets, value of revealed fixed assets, and investment outside the business, capital, works in progress, miscellaneous expenditure and loss) and current assets minus current liabilities existing at the beginning and close of the financial year.

(a) Net worth: Net worth is defined as share capital plus reserves and surplus less accumulated losses and intangible assets.

(b) Profit: It means profit after providing for depreciation and all the other expenses except interest on borrowings but before providing for taxes and income, for the companies as a whole and for the product under the reference.

(c) Net sales: Net sales means excluding sales returns, excise duties, sales tax, octroi and other local taxes, for the product under reference and for the company as a whole.

(d) Operating profit : Operating profit is the excess of the operating revenue over the operating expenses for the product

(e) Ratios: Ratios are expressed in terms of value in rupees and as a percentage.

(f) Value addition: This is defined as the difference between the net output value and the cost of bought out materials and services for the product under the reference.

• **Raw materials**

The cost of the major raw materials consumed both in terms of quantity and value is estimated. Further, the quantity of consumption of major raw materials and the value of raw materials and components finished and semi-finished that have not moved for over twelve months and above indicate their proportion to the value of the stock at the end of the year.

• **Process of manufacture**

A detail description of the process of manufacture along with a flow chart of the product reference is provided.

• **Production**

Each type of product under the reference and for each factory is to be given, with regard to registered/licensed capacity, installed capacity, actual production and the production capacity enhanced by leasing as well as all details of added capacities and other utilizations along with the percentage of production to installed capacity.

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• **Wages and salaries**

All categories of employee's total wages and salaries are examined separately in respect of the following:

(i) Direct labour cost on total production

(ii) Indirect labour cost on production

(iii) Employee cost on administration

(iv) Employee cost on selling and distribution

(v) Other employee cost and total employee cost

• **Power and fuel**

The following information is to be provided with regard to consumption of power and fuel:

(i) Details of quantity rate per unit and total cost in respect of the power and fuel used in the production coal, electricity, oil, etc., and other utilities separately

(ii) A comparison of the actual physical consumption per unit of the production of the product under the reference with standards budgeted, if any, with the preceding two years consumption and an interpretation on the difference

(iii) Impact on the other unit cost of production of the product under reference due to measures taken for energy conservation.

• **Repairs and maintenance**

(i) This constitutes the expenditure/per unit of output of the product under reference for the current financial year and for the preceding two financial years for the stores and spares, labour charges and outside the contract repairing charges.

(ii) Further, it also contains the amount and the proportion of closing the inventory of stores and spare parts representing items.

• **Depreciation**

(i) This constitutes the method of depreciation adopted by the company, if the company has not provided in full an explanation for the depreciation worked out in accordance with the Section 123 of the Companies Act 2013.

(ii) The basis of apportionment of the depreciation on common assets to different departments/cost centers and the final absorption in the products under reference shall be provided.

• **Overheads**

(i) The overheads both for the company and factory are given separately from the total amount.

(ii) The basis followed for allocation and apportionment of the common overheads including head office expenses to the product, capital works and the other activities of the company shall be provided.

(iii) The basis adopted for absorption of overheads to cost centers and product shall also be given.

- **Sales**

(i) This constitutes the sales in quantities and the net sales realization of the product under reference showing the average sales realization/per unit.

(ii) If the product under reference is exported then details of the quantity exported, net realization/unit, countries to which exported and also the profit /loss incurred in exports is to be provided.

(iii) Where the product is sold at different prices in accordance with the government policy, the sales realizations of each product at different prices shall be shown separately along with the quantity and value.

(iv) Whether the net sales realization includes the cost of packing, freight and delivery charges recoverable from the customers or not shall also be provided.

- **Abnormal non-recurring costs**

This pertains to the abnormal features affecting production during the year, such as strikes, lockouts, major break down in the plant, substantial power cuts, serious accidents, etc.

- **Auditors observations and conclusions**

The cost auditor can give his observations and conclusions relevant to the cost audit.

The report, suggestions, observations and conclusions given by the cost auditor under this paragraph shall be based on verified data reference which shall be made here and shall wherever practicable be included after the company has been afforded an opportunity to comment on them.

The cost auditor suggests measures for improvements in performance if any, in respect of the following:

(i) Clarification of general imbalance in production facilities.

(ii) Utilization of installed capacity, concentration on cost reduction and increased productivity as well as improved inventory policies.

The cost auditor shall ensure that the report along with the annexure is sent by registered post (or) other wise delivered in person to the Central Government through a messenger and an acknowledgement obtained.

If the company has more than one factory producing the product under reference, the cost auditor shall provide separate details indicating in the annexure details concerning each factory.

If different varieties/types of production are manufactured by the company, the cost auditor shall give details of cost in respect to each variety and type of such products in the annexure as well as the proforma.

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Proforma of a Cost Audit Report

The following is the proforma of a cost audit report:

Form CRA – 3

[Pursuant to Rule 6(4) of the Companies (Cost Records and Audit) Rules, 2014]

FORM OF THE COST AUDIT REPORT

I/We,... having been appointed as Cost Auditor(s) under Section 148(3)of the Companies Act, 2013 (18 of 2013) of .... *(mention name of the company)* having its registered office at .... *(mention registered office address of the company)* (hereinafter referred to as the company), have audited the Cost Records maintained under section 148 of the said Act, in compliance with the cost auditing standards, in respect of the...................................[mention name (s) of *Product*(s) / service(s)] for the period/year............................ *(mention the financial year)* maintained by the company and report, in addition to my/our observations and suggestions in para 2.

(i) I/We have/have not obtained all the information and explanations, which to the best of my/our knowledge and belief were necessary for the purpose of this audit.

(ii) In my/our opinion, proper cost records, as per Rule 5 of the Companies (Cost Records and Audit) Amendment Rules, 2014 have/have not been maintained by the company in respect of product(s)/service(s) under reference.

(iii) In my/our opinion, proper returns adequate for the purpose of the Cost Audit have/have not been received from the branches not visited by me/us.

(iv) In my/our opinion and to the best of my/our information, the said books and records give/do not give the information required by the Companies Act, 2013, in the manner so required.

(v) In my/our opinion, the company has/does not have adequate system of internal audit of cost records which to my/our opinion is commensurate to its nature and size of its business.

(vi) In my/our opinion, information, statements in the annexure to this cost audit report gives/does not give a true and fair view of the cost of production of product(s)/rendering of service(s), cost of sales, margin and other information relating to product(s)/service(s) under reference.

(vii) Detailed unit-wise and product/service-wise cost statements and schedules thereto in respect of the product/service under reference of the company duly audited and certified by me/us are/are not kept in the company.

2. Observations and suggestions, if any, of the Cost Auditor, relevant to the cost audit.

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Dated: this ____ day of __________ 20

at ________ (mention name of place of signing this report)

SIGNATURE AND SEAL OF THE COST AUDITOR (S)
MEMBERSHIP NUMBER (S)

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(1) Delete words not applicable.

(2) If as a result of the examination of the books of account, the Cost Auditor desires to point out any material deficiency or give a qualified report, he/she shall indicate the same against the relevant para (i) to (vi) in the prescribed form of the Cost Audit Report giving details of discrepancies he/she has come across.

(3) The report, suggestions, observations and conclusions given by the Cost Auditor under this paragraph shall be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.

Qualified Report

The auditor's report is the final result of every audit. It is the medium through which the cost auditor expresses his opinion on the cost accounts and cost records. The audit report describes the scope of the audit and opinion of the auditor. The scope of the auditor consists of a representation of the work to be performed. It shows the extent of the work to be carried out in his examination and the judgment, observations as well as the suggestions of the cost auditor.

An auditor may submit the report to the company law board and to the management of the company in two ways, i.e., clean (or) unqualified report and qualified report.

(i) **Clean report (or) unqualified report:** When the auditor is satisfied as to the fairness of the cost accounts and records, he will provide a clean report. In other words if the auditor makes the various statutory affirmations without reservations, he is said to have given an unqualified report on the cost accounts and cost statements of the company.

(ii) **Qualified report:** When the auditor is not satisfied with the accounts presented to him (or) if he finds some discrepancy in the treatment given to him or he thinks that the cost statements do not exhibit a true and fair view of the state of company affairs and the management is not prepared to make the desired changes, he will quality his report. This implies that when

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an auditor gives an opinion subject to qualify certain reservations, he is said to have given an unqualified opinion /report. Thus, the qualified report is the report given by the cost auditor when he finds that items in cost statements or records are misstated to such an extent that the statement does not give a true and fair view. A qualified report is not necessary unless the issues involved are material. Before a qualified report is given by the auditor he is required to:

- Ascertain the statement of facts and opinions that require a qualification.
- Examine whether adequate information is lacking.
- Verify whether the matter in question is material which affects the presentation of the true and fair view of the affairs of the company.
- Analyse whether the matter constituting qualification involves a material contravention of the rules of the Companies Act of 1956.

The Companies Act does not mention any qualifications but the ICAI has formulated standard practices known as the Auditing and Assurance Standard (AAS) effective from 1st April 1985. Hence, the financial auditor or the cost auditor has to comply with this standard when a qualified report is prepared.

Cost Accounting Records

Under Section 2, clause 13 provides that a company engaged in production, processing, manufacturing, or mining activities should keep proper books of accounts showing such particulars relating to utilization of materials or labour or to other items of cost as may be prescribed, if such class of company is required by the Central Government include such particulars in the books of account.

Provided that all or any of the books of account aforesaid may be kept at such other place in India as the board of directors may decide.The company shall, with in seven days of the decision file with the Registrar a notice in writing giving the full address of that other place.

Types of Cost Accounting Records

The following are certain significant cost records which are required to be maintained by the company:

(i) Materials: Adequate records of receipts, issues and balances and the consumption of each item of material including components that have been purchased are required to be maintained both in quantities and value. The cost of loss of material in transit, during storage or for reason is to be worked out separately and the treatment of such losses in the accounts is indicated. The cost shall include all direct charges. If the quantity and value of material consumed are determined on any basis other than the actual, the method adopted shall be indicated in the cost records. The overall reconciliation of such value of material with the actual and the treatment of such variations is kept as record.

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(ii) Consumable stores, small tools and machinery, spares etc: Adequate records showing the receipts, issues and balance including consumption of each item are to be maintained in the same manner as for materials

(iii) Services: Adequate records are to be maintained to ascertain the cost of power, fuel, etc. If power is purchased the purchase cost is required to be shown separately.

(iv) Wages and salaries: Proper records shall be maintained to show the attendance and earnings of all departments and employees or cost centers and the work on which they are employed. The idle time cost is calculated and recorded separately. The system of incentives is remuneration paid, if any are to be indicated.

(v) Overheads: These must be segregated into works selling and distribution and administration overheads. The method of their allocation, apportionment, collection and recovery in output are to be indicated.

(vi) Work-in-progress: The value of work-in-progress should include materials, overheads, salary and depreciation. The records should also show the quantities of work-in-progress.

(vii) Reconciliation of financial and the cost accounts: A reconciliation of profit as displayed by the cost and financial accounts is done every year.

(viii) Service department expenditure: Each and every service department of expenses is to be calculated separately, the apportionment and allocation of expenses to these departments are also required.

(ix) Depreciation: According to the Companies Act 1956, the amount of depreciation charged in the cost accounts must be in accordance with rules and regulations. Proper records should be maintained in respect of depreciation charged on all fixed assets.

(x) Royalty and payment of technical aid: The basis of calculating the amount of royalty charged and other allied payments to the production costs are to be recorded.

(xi) Stock verification: Records of stock verification should be maintained in respect of all raw materials, stores, spare-parts, components including loose tools and other materials kept in stocks.

Check Your Progress

1. Who appoints the cost auditor and the financial auditor?
2. What is the main duty of a cost auditor?
3. What are cost audit notes?

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11.3 APPROACH TO EDP AUDITING AND AUDITING WITH COMPUTER: ADMINISTRATIVE AND PROCEDURAL CONTROL

An EDP (Electronic Data Processing) environment exists when a computer of any type or size is involved in the processing of financial information of significance to the audit. The scope, objectives and general approach do not change when an audit is carried out in an EDP environment. However, the nature, timing and extent of audit procedures are likely to be affected by the characteristics of that system. As such it is important for the auditor to obtain an understanding of computer processing before an audit is conducted.

By way of initial observation it may be stated that, when undertaking an audit assignment in an EDP environment, the auditor should necessarily have an understanding of computer hardware, software and processing systems sufficient enough to plan the assignment and to understand how EDP affects the study and evaluation of internal control and the application of auditing procedures depending on the particular audit approach adopted. It is equally important that when the auditor delegates work to assistants, or makes use of work performed by other auditors and experts, he should have enough knowledge of EDP to direct, supervise and review the work of assistants with EDP skills, or to obtain reasonable assurance that the work performed by other auditors and experts with EDP skills is adequate for his purpose.

Planning an Audit in a Computer Environment

In order to plan an audit in a computer environment, the auditor should gather information about the environment that is relevant to the audit plan, including information as to:

(a) how the audit function is organized and the extent of concentration or distribution of computer processing throughout the enterprise;

(b) the computer hardware and software used by the enterprise;

(c) each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies;

(d) the planned implementation of new applications/installations or amendments to existing new applications/installations.

As an essential first step in considering an overall plan, the auditor has to make an appraisal of the enterprise's accounting procedures and internal control. This should enable him to make an informed assessment of:

(a) the degree of reliance which the auditor expects to place on the EDP controls in his overall evaluation of internal control;

(b) the most effective method of selecting and substantiating transactions or balances;

(c) the most cost-effective method of conducting the audit, namely by either compliance testing or direct substantive testing.

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Problems Encountered in an EDP Environment

Among the problems encountered in an EDP environment, the following are important:

1. The usual controls based on proper segregation of incompatible functions may be absent or may be less effective in an EDP environment. This is because the number of persons involved in the processing of financial information in an EDP environment is comparatively small. Moreover, the need for a centralized data processing function means that certain data processing personnel may be the only ones with a detailed knowledge of the source of the data, how it is used and the distribution and the use of output. This may also mean that they are familiar with the internal controls operating and hence may be in a position to alter the programs or data during processing or while stored. These factors increase the possibilities for manipulation.
2. Poor security for master files - they may be tampered with or lost.
3. Transaction and master file data are often concentrated either in one computer installation located centrally or in a number of installations distributed throughout the enterprise. Computer programs which provide the ability to obtain access to and alter such data, are likely to be stored at the same location as the data. This increases the possibilities for unauthorized access to, and alteration of, programs and data.
4. Vulnerability of data and program storage media - Magnetic discs or tapes on which large volume of data are stored while using EDP methods are vulnerable to theft, loss, or intentional or accidental destruction.
5. Poor facilities in case of misfortunes, e.g. fire, breakdowns, etc.
6. Lack of control over computer service personnel.

The common weaknesses mentioned above relate to the organizational structure of an EDP environment. In addition, system characteristics which result from the nature of EDP processing include the following:

1. There is every possibility for the audit trail to get obscured by the loss of visibility of the accounting records, and the increased amalgamation and summarisation of data by computer programs. On the other hand, in a manual system it is possible to follow a transaction through the system by examining source documents, records, files and reports.
2. Data may be entered directly into the computer system without supporting documents.

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3. Computerised data may not be retained for as long as manually prepared accounting data.
4. Through the use of remote terminals, it may be possible for unauthorised access to, and alteration of, programs and data by persons inside or outside the enterprise.

Internal Controls in an EDP Environment and the Auditor

Control procedures in an EDP environment cover both manual procedures and computer procedures. Such control procedures may be grouped into General EDP Controls and EDP Application Controls.

(a) General EDP Controls (Installation Controls)

These are overall controls affecting the EDP functions. They relate to all EDP activities and their objectives. Their essential characteristics do not change with the method of data processing. They include:

1. Organisation and management controls These relate to policies and procedures concerning control functions and proper segregation of incompatible functions.

These controls are achieved mainly through the following:

(a) The computer department is separated physically and managerially from the user sections.

(b) The following functions are segregated and performed by different personnel in the computer department:

(i) system design and programming;
(ii) system support;
(iii) computer operations;
(iv) media storage;
(v) data preparation.

(c) a separate data control group is entrusted with the work of receiving and controlling data sent for processing.

2. Computer operation controls: These relate to the controls over access to computer and to assure that the systems are utilised only for authorised purposes by properly authorised personnel. Besides, they aim at the early detection of errors during processing. These controls are achieved mainly through the following:

(a) The person who operates the computer and the one who prepares the data will be different.

(b) Controls over physical access to the computer are exercised by -

(i) Keeping the computer in a locked room, a key only being available to authorised personnel.
(ii) Locking the computer so that a key is required to switch on the electrical
supply.

(c) A record is kept each time the computer is used by using a manual log. Or else, the record is incorporated into the programs so that the print out is sequentially numbered each time the program is used.

(d) Errors in data input into the computer are highlighted at the editing stage, before processing commences. Data will continue to be input into the computer in batches, and the batch control total calculated by the computer, will be agreed with that calculated manually, before any data is accepted for further processing. A Batch Control Book is usually maintained so that the proper processing of data is checked and the correction of rejections verified.

3. Data entry and program controls: The objects of these controls are to ensure that a proper authorisation structure is established over transactions being entered into the system, and only properly authorised personnel, are permitted access to data and programs.

These controls are achieved mainly through the following:

(a) Physical access to files is controlled by keeping them in the custody of a person independent of those who use the computer. These files are kept under lock and key, and they are issued only to authorised personnel, after recording their issue and return in a register.

(b) Use of programs is controlled by means of pass words. Under strict conditions, each individual will have his/her own pass word which allows only him/her to perform authorised functions. Also, these pass words are periodically changed.

(c) Data which is to be input into the computer is authorised by a responsible official, before it is accepted by the computer operator.

4. Systems development and maintenance controls: The object of such controls is to provide reasonable assurance that systems are developed and maintained in an authorised and efficient manner. Also, they endeavour to establish control over changes to application systems; testing, conversion, implementation and documentation of new or revised systems; and access to systems documentation. This point is further elaborated in a subsequent section titled "Systems Development". The reader's attention is invited to that section.

5. Systems software controls: These controls relate to the acquisition or development of systems software. They include authorisation, approval, testing, implementation and documentation of systems software modifications. They also aim at ensuring that access to systems software and documentation is restricted to authorised personnel.

Measures designed to achieve the controls mentioned in (4) and (5) above are:

(a) In the case of proposed amendments to application programs, procedures are laid down for management authorisation, through testing before acceptance for live running, management review of the changes effected and the maintenance of adequate records.

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(b) Highlighting unauthorised amendments of programs by:
   (i) numbering the printout each time the program is used - any break in the sequence will indicate unauthorised use of the program;
   (ii) using manually calculated control totals (e.g. purchase ledger control account) - this will indicate any unauthorised adjustment to transaction files;
   (iii) printing out the opening and closing balances on the transaction file each time it is updated, e.g. with a purchase ledger, it is possible to check the opening balance with the closing balance on the previous run, and the closing balance with the opening balance on the next run;
   (iv) calculating control totals of standing data files which could be checked before and after the file is updated, and even printed out each time the file is used.

(c) Procedures similar to those mentioned above are laid down as amendments to the systems software.

(d) Standard procedures are laid down for separating "live" and "test/development" programs. Access to both live and test directories is restricted by means of pass words.

(e) Data stored in magnetic files will be restricted to personnel who are authorised to handle such files and the computer operators. User department personnel who maintain financial records, and system analysts and programmers whose duty is to design systems and write minute instructions, will not be allowed access to both magnetic files and the computer.

(f) Procedures will be laid down for the orderly rotation of duties and applications performed by the operators in such a manner that no single operator is allowed to have permanent access to the same files of information.

(g) Data Processing Manager will have to authorise requests from the operators for the issue of files by the librarian. All issues and receipts will be strictly controlled and recorded by the librarian. More rigid measures will be there concerning highly confidential information. Access to such information will be limited to a select few members of staff.

6. Back up and recovery controls: The objects of these controls are offsite maintenance of data and programs, standby facilities whereby vital processing can continue in the event of equipment failure, and recovery for use in the event of theft, loss, deterioration or destruction of data and programs.

Measures aimed at achieving the above include:

(a) Normally, a library located at a place different from the computer complex will be established. The librarian who is in charge of this place will be entrusted with the task of maintaining all files and also to ensure appropriate atmospheric conditions with regard to temperature, humidity, dust, etc. for the protection of the files.

(b) In the case of magnetic tapes, 'generation filing system' is implemented. Under this system, three generations of files are maintained until the contents of the fourth generation have been processed and verified for accuracy and completeness. For instance, in the case of purchase ledger, three successive months of the purchase ledger accounts are maintained until the fourth month's accounts have been verified, when the first of the files is discarded and used for some other purpose. This is known as the "Grandfather, Father, Son" principle. At least three generations of files (Grandfather, Father and Son) are held in order to cater to any corruption of the Father when producing the Son. Sometimes it will be necessary to hold more than three generations of files. Old generations are held for at least as long as the time between the control checks, that would detect alterations at any level. Where there is a monthly reconciliation, then the retention of old masters and input files for at least one month would be necessary. The 'generation filing system' enables the reconstruction of master files in case of accidents during processing.

(c) In the case of disc-based systems, copies of the contents of discs (or, selected important areas) are taken periodically for retention (these copies are known as 'dumps'). In order to safeguard against faults in the disc or disc drive, a different disc pack is used where dumping is to disc.

(d) Procedures relating to the method of file recovery are properly documented. A copy of the documentation is held remotely.

(e) Standby arrangements are made whereby vital processing is continued in an uninterrupted manner, either on another computer or by another user of similar equipment in the event of a breakdown. These standby arrangements are tested at least annually or immediately after significant changes have occurred at either site.

(b) EDP Application Controls

EDP Application Controls are intended to establish specific control procedures over the accounting applications with a view to providing reasonable assurance that all transactions are authorised, properly recorded and are processed completely, accurately and on a timely basis. They include:

1. Documentation controls: The objective of documentation controls is to ensure that adequate and uptodate system documentation is maintained. These controls are established by means of:

(i) ensuring that system documentation is sufficiently comprehensive to include system overview, overview of the application and how it interfaces with other systems; a detailed description of the application, program, internal controls and reconciliation, feasibility and validity checks input/ output descriptions and file control descriptions;

(ii) updating of documentation to reflect all system amendments;

(iii) remote maintenance of back up copy of the documentation.

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2. *Input controls:* These controls are established in order to ensure that:

(a) input data is complete and accurate;

(b) transactions are properly authorised before being processed by the computer;

(c) transactions are accurately and completely converted into machine readable form for processing by the computer and recorded into the computer data files;

(d) improper or unauthorised changes are not effected in the transactions; and

(e) rejection, correction and, where necessary, resubmission are made on a timely basis.

Input controls are of vital significance in that they enable the detection and correction of errors before they cause incorrect processing or incorrect output. Also, experience indicates that the main source of error or fraud in computerised systems is incorrect or fraudulent input.

Input controls are established by means of the following:

(i) Appropriate authorisation of all prime input, including alterations to standing data. Alterations or amendments to standing data are usually subject to a stronger level of control than transaction data. Authorisation is evidenced through the signature of the appropriate official on the document. Specimen signatures are maintained to check the authenticity of the input.

(ii) Where an on-line terminal system exists, the ability to enter data from a terminal is restricted and controlled through proper identification and adequate checking of his authority to input data. Identification and restriction are achieved by a hierarchy of passwords and permissions.

(iii) Cancellation of source documents by stamping or perforating input forms as they pass through the input phase so as to prevent duplicate processing. (This may not be necessary where a compensating control exists somewhere else. For instance, where the computer performs a sequence check or where the computer is programmed to detect duplicate input.)

(iv) Ensuring that all authorised input has been submitted/transmitted.

(v) Ensuring the completeness and accuracy of data at sufficiently early stages in the processing cycle, thus avoiding the possibility of documents being either lost or tampered with or of additional ones being inserted. Contents of a batch during processing are controlled through batch control totals. The number of documents in each batch and the totals of any quantitative field such as monetary values or stock quantity are accumulated and checked with a view to ensuring completeness of processing. Agreement of these totals at later stages of processing will indicate whether all input has been received.

(vi) Ensuring that errors occurring when data is keyed from clerical informations are detected at the earliest and corrected.

(vii) Ensuring that data which has been rejected is promptly reported stating the reasons for rejection, and laying down procedures for the subsequent correction and re-entry.

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3. Processing controls: These controls are established in order to ensure the complete and accurate processing of input and generated data. In particular, they are designed to ensure:

(a) the proper processing (by the computer) of the transactions, including system generated transactions;

(b) that transactions are not lost, added, duplicated or improperly altered;

(c) the identification and correction of processing errors. Processing controls are established by means of:

(i) ensuring proper validation of input and generated data, thereby ensuring that only valid transactions are processed;

(ii) ensuring that errors detected during processing are rejected and referred

back to the originators for re-processing;

(iii) ensuring that transfer of data from one processing stage to another is adequately controlled. For this purpose run-to-run controls (file control totals to check records passing from one run to another) are used. Where records are rejected by a process, the control totals are altered to reflect this.

4. Output controls: These controls are established in order to ensure accuracy, completeness and orderly authorisation of output. In particular, they are designed to ensure that :

(a) results of processing are accurate and complete;

(b) output is restricted to authorised personnel, and only under strict control;

(c) output is physically controlled at all times, depending on the confidentiality of the document.

Output Controls are established by means of the following:

(i) Output is subject to an overall reconciliation with originating input, which is carried out by a control section or the user. All prints and reports are terminated by an appropriate message to enable recipients to check that they are complete.

(ii) Proper procedures are laid down regarding details as to who should receive output and any special requirements such as receipts for sensitive information. Also, proper precautions are taken to ensure that output awaiting collection or despatch is not left unattended or passed to unauthorised third parties.

(iii) Unused cheque leaves are kept under safe custody. Issues are controlled by serial numbers. A log book is maintained showing receipts, issues and balance. Spoilt cheque leaves are recorded, cancelled and retained for checking. Independent checks are carried out by a responsible official independent of the one issuing them.

5. Master file controls These controls are established in order to ensure the accuracy, completeness and proper authorisation of data contained in Master Files and Standing Data Files. Master Files contain data which is updated/amended on every run of the system. Data contained in Standing Data Files are updated periodically and these are referenced during the processing cycle. In addition to these files being used in everyday processing, they are also used in the preparation of final accounts. In other words, inaccuracies in these files in a system will mean that the final accounts produced are wrong.

Master File Controls are established by means of:

(i) Proper control and authorisation of all amendments to standing data.

(ii) Verification of the integrity of Master Files and Standing Data Files by checking control totals, and periodical reconciliations with independently held records.

(iii) Control and restriction on physical and logical access to application data files.

Systems Development

Systems development procedures consist of System Testing Procedures and Data Transfer Procedures.

(a) System Testing

The control objective of system testing is to provide adequate assurance that the system was properly tested before commencing live operations. While examining system testing, the auditor should give emphasis to the following points:

(a) The strategy for testing the new system should include a detailed and comprehensive plan covering both computerised and manual procedures. This testing should be on the following lines in the case of large in-house developments:

(i) Design validation A program walk-through is carried out by a team usually consisting of the programmer, system analyst and the team leader. The object is to ensure that the program design is correct and conforms to the requirements of the specification.

(ii) Program testing Test data is processed on the new program (module) and the results obtained are compared with expected output. These are known as TEST SHOTS. The object is to make sure that the program code reflects correctly the design of the new system.

(iii) Link suite testing Where all test shots as above have been run without error, the next level of testing known as LINK SUITE TESTING can be undertaken. The object of this test is to test program logic. It consists of running the individual programs together to make sure that they link properly.

(iv) System testing including regression testing The stage is now ready for a full testing of the total system which covers the full transaction flow and record maintenance procedures. Both valid and invalid data should be used in carrying out these tests and analysing the results. Any errors detected should be corrected and resubmitted using the same data. The test strategy should include documented procedures for resolving these errors. Management should formally clear the corrected program. The daily processing cycle and the infrequent processes (e.g. month-end and year-end) should be included in the testing. In order to check the ability of the system to carry out full processing task within the allotted time, the final part of this testing should involve the use of full workloads. Strictly speaking, a repetition of all the tests conducted previously would assure that new errors have not crept into the revised loading. This is called REGRESSION TESTING.

Involvement of top level management is essential during system development stages. At each check point, the approval of top level management should be required to proceed. In such matters as planning the testing, providing the test data and evaluating the results, the user should also be involved. Ideally, full parallel running, under which both the old and the new systems are run in parallel and the results of each compared, should be carried out for testing the new system. But because of the high expenses involved, this is not always practical. In that case a PILOT SCHEME is the usual method. Under this only part of the new system is run, or, full running at only one of the several sites is resorted.

(b) The user should evaluate the results of testing and where satisfactory, should accept the test results in writing.

(c) An officer in a senior management position, should provide the relevant authority to commence live operations after satisfying himself that the test results are satisfactory and the system works.

(b) Data Transfer

Weaknesses in data transfer procedures will result in the relevant records being transferred incorrectly from the old system to the new system. Hence it is of utmost importance that all relevant precautions have been taken, to make sure that data from the old system was correctly transferred to the new system. Accurate transfer of the opening balances and data is the first stage. Any error at this stage will have a direct impact on the accounts as a whole. Similarly Master Files and Standing Data are to be set up accurately since errors in these will affect all subsequent transactions. In ensuring accurate data transfer, the following points should be observed:

(a) There should be effective controls to ensure the accuracy and completeness of data conversion.

(b) Testing of data transfer should include checking of a sufficient volume of data back to the original data.

(c) Management should review the checks on data transfer and should approve the validity of the new system's file. The tests carried out by the management should be properly documented and reviewed, and documents should be retained for audit inspection.

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Check Your Progress

4. When does an EDP environment exist?
5. What does the systems software controls include?
6. What are EDP application controls are intended to establish?

11.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The cost auditor is appointed by the Board of Directors or Central Government and the financial auditor is appointed by the shareholders in the general body meeting.
2. The main duty of the auditor is to prepare the audit report and to submit it to the company/Government.
3. Cost audit notes refers to a record which contains information on the significant facts discovered by the cost auditor in the audit, important clarifications sought, clarifications given by the concerned parties, his satisfaction or dissatisfaction on such clarifications, defects in the system of internal control frauds, manipulations, misappropriations, etc.
4. An EDP (Electronic Data Processing) environment exists when a computer of any type of size is involved in the processing of financial information of significance to the audit.
5. The systems software controls relate to the acquisition or development of systems software. They include authorisation, approval, testing, implementation and documentation of systems software modifications.
6. EDP Application Controls are intended to establish specific control procedures over the accounting applications with a view to providing reasonable assurance that all transactions are authorised, properly recorded and are processed completely, accurately and on a timely basis.

11.5 SUMMARY

- Cost audit is mainly preventive measure, a guide for management policy and decision, in addition to being a barometer of performance.
- Ensuring that the cost accounting records are drawn properly is one of the important objectives of cost audit. Cost auditor has to ensure that the cost records are prepared in accordance with the standards specified.
- The main object of financial audit is to see whether proper records of accounts are maintained and to ensure that income statement and balance sheet reveal true and fair view of the affairs of the company.

- The company (Amendment) Act 1965, has introduced two new sections, i.e., Section 209 clause (d) and Section 233 (B) pertaining to cost audit. According to section 209 (d) the Central Government acquires powers to cost audit in cases of those companies that are engaged in production, processing or mining activities, etc. According to Section 233 (B), an audit conducted by a cost auditor shall be in addition to the audit conducted by an auditor under Section 224 of the Companies Act 1956 and section 143 of Companies Act 2013.
- On receipt of the order of the Central Government, directing the company to have a cost audit conducted, the board of directors passes a resolution either at a meeting or through a circulation appointing a cost auditor, subject to the appeal of the Centre. The Central Government communicates approval to both the company and the proposed cost auditor. A formal letter of appointment is then issued to the cost auditor by the company.
- The prior approval of the company law board is essential for appointing the cost auditor.
- The appointment of cost auditor is valid for the year for which he is appointed. The Central Government has recently permitted the cost auditor's appointment for two terms. The application for the re-appointment or change of auditors may be made only after the expiry of the two terms.
- With regard to inventory, the cost auditor has to discharge a number of functions, such as coverage of shortage and carrying costs in optimum order size, valuation of inventory, supervision of materials, stores and supplies procurement and issues, supervision of expenditure on consumable stores, etc.
- According to the Cost and Works Accountants Act 1959, an incoming cost auditor should communicate with the previous cost auditor. In this regard, the Institute of Cost and Works Accountant of India has opined that 'Communication means a letter addressed by the member previously holding the position of the cost accountant in the same company. Normally, a categorical reply to such a communication is not a necessary pre requisite for the acceptance of the appointment.'
- A cost report constitutes all the elements of a report except that it is always presented in financial terms. It primarily presents feedback information. Emanating from a specialist branch of accounting, cost report necessarily conveys figures about costs, revenues, profits, investments and restated matters in actual budgeted and standard costs.
- The primary objective of a cost audit report is to provide desired information to management, in a comprehensive and functional form.
- An EDP environment exists when a computer of any type or size is involved in the processing of financial information of significance to the audit.

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- The scope, objectives and general approach do not change when an audit is carried out in an EDP environment. However, the nature, timing and extent of audit procedures are likely to be affected by the characteristics of that system.
- Control procedures in an EDP environment cover both manual procedures and computer procedures. Such control procedures may be grouped into General EDP controls and EDP Application Controls.
- Systems development procedures consist of System testing procedures and data transfer procedures.

11.6 KEY WORDS

- **Cost Audit**: It represents the verification of cost accounts and check on the adherence to cost accounting plan
- **Undertaking:** It refers to a company or business.
- **Financial report:** It is a formal record of the financial activities and position of a business, person, or other entity.

11.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Differentiate between cost and financial audit.
2. What are the provisions related to the disqualification of a cost auditor?
3. Write a short note on the rights of a cost auditor.
4. List the guidelines to keep in mind while undertaking the preparation of a cost audit report.
5. Briefly explain the types of cost accounting records.
6. What are the steps involved in planning an audit in a computer environment?
7. List the problems encountered in an EDP environment.
8. Write a short note on the systems development procedures in EDP.

Long Answer Questions

1. Explain the objectives of cost audit.
2. Discuss the appointment of cost auditor.
3. Assess the various functions of a cost auditor.

4. Describe the major contents of a cost audit report.
5. Examine the duties of a cost auditor.
6. Describe the general and overall controls affecting the EDP functions.
7. Discuss the EDP application controls.

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11.8 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

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BLOCK IV
AUDIT OF SPECIAL INSTITUTION AND INVESTIGATION

UNIT 12 AUDIT OF SPECIAL INSTITUTIONS

Structure

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12.1 Objectives
12.2 Role of an Auditor on Verification of Reports
  12.2.1 Other Information Issued with Audited Financial Statements
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12.3 Audit Procedures for Special Institutions
  12.3.1 Audit of Club
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  12.3.4 Audit of Cinema
12.4 Answers to Check Your Progress Questions
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12.0 INTRODUCTION

Up till now, you have learnt about the procedures involved in auditing with regards to company audit as well as cost audit. You also learnt about the developing field of management audit. In this unit, we move beyond the boundaries of company accounts to discuss different types of institutions which are not always made with the objective of selling products for profit. These institutions may be in the field of entertainment or in the social field. But these do involve money and finances and therefore it is prudent that proper books of accounts are kept and audited periodically to ensure that they are functioning properly. There are also certain institutions which are run for profit like cinema but include certain special aspects which are different from normal corporate institutions. In this unit, you will learn about the auditing of special institutions including audit of clubs, hostels, hospitals and cinema. But before that we should briefly discuss the role of an auditor on verification of reports.

12.1 OBJECTIVES

After going through this unit, you will be able to:

- Discuss the role of an auditor on verification of reports
- Explain the audit of club, hostels, hospitals and cinema

12.2 ROLE OF AN AUDITOR ON VERIFICATION OF REPORTS

The appraisal of the financial position of any company is revealed through the auditor's report. As you have already learnt in the previous units, the auditor's report is prepared on the basis of the financial statement of the company. Therefore, it is important that the auditor ensures that the standards and provisions mentioned regarding the maintenance of books of accounts by accounting standards and the Company Law has been adhered to by the organization and present a true and fair view of the organization. In this section, you will learn about the role of an auditor after he conducts the verification of reports. These will include a discussion on the other reports submitted along with the auditor's report, post balance sheet events and auditor', questions regarding materiality, true and fair view and going concern.

12.2.1 Other Information Issued with Audited Financial Statements

It is usual for a business enterprise to issue on an annual basis a document referred to as the "annual report" which includes its financial statements together with the audit report. In issuing such a document, the enterprise may include, either by law or custom, in addition to the audited financial statements, other financial and non-financial information. 'Other Information' referred to in the heading includes such financial and non-financial information. Examples of 'other information' include Chairman's statement, a report by management or Board of directors on operation, financial summaries or highlights, employment data, planned capital expenditure, financial ratios, etc. The auditor may or may not have a statutory/contractual obligation to report specifically on 'other information'. Whether required by statute or not, it is necessary for the auditor to give careful consideration for such 'other information' when issuing his report on the financial statements in view of the fact that it is his sacred duty to ensure that the credibility of the financial statements has not been undermined by inconsistencies which may exist between the financial statements and 'other information'.

International Auditing Guideline issued in 1984 provides guidance on the following lines as to the auditor's consideration of 'other information' on which he has no obligation to report. It may be made clear in this connection that where an auditor has no obligation to report specifically on 'other information', his responsibilities are determined by the nature of his engagement.

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The auditor should make appropriate arrangements with his client to obtain 'other information' included in the annual report prior to the date of his report. While the auditor has no responsibilities to perform audit procedures to determine that such 'other information' is properly stated, he should read the 'other information' to determine that it is not materially inconsistent with the financial statements. During the course of doing so, the auditor may become aware of any material misstatement of fact.

Material Inconsistencies

Matters which may give rise to an inconsistency include the following:

(i) an inconsistency between the actual figures or narrative appearing in respectively, the financial statements and the directors' report;

(ii) an inconsistency between the bases of preparation of related items appearing in the financial statements and the directors' report, where the figures themselves are not directly comparable and the different bases are not included;

(iii) an inconsistency between figures contained in the audited financial statements and a narrative interpretation of the effects of those figures in the directors' report.

In the majority of cases, the auditor will be able to achieve elimination of any inconsistent or misleading item through discussions with the top management and by giving appropriate advice as to whether the financial statements or the 'other information' need revision. Accordingly further action as described below will not normally become necessary. In case the auditor is of the opinion that a revision is necessary in the financial statements and the management refuses to make the revision, it will become necessary for the auditor to express a qualified or adverse opinion, as appropriate.

In case the auditor is of the opinion that a revision is necessary in the 'other information' and the management refuses to make a revision, the auditor should consider including in his report an explanatory paragraph describing the material inconsistency, or performing other actions, such as the withholding of his report in the document or even withdrawing from the engagement. The action taken will depend upon the particular circumstances and the nature and significance of the uncertainty.

Material Misstatement of Fact

It may so happen that the auditor becomes aware that the 'other information', though not inconsistent with the financial statements, nevertheless appears to include a material misstatement of fact. As observed earlier, the matter should first be discussed with the management. If, after discussions with the management, the auditor still believes that he has a basis for concern as to the validity of the 'other

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information', he should request the management to consult with some other party, such as the legal advisors of the business and he should consider the opinion received.

In case the auditor comes to a conclusion that there exists a material misstatement of fact which the management refuses to correct, he should consider such steps as notifying the management in writing of his concern regarding the 'other information' and obtaining legal advice as to further appropriate action.

Other Information Received After the Date of the Audit Report

In certain circumstances, all the 'other information' may not be available to the auditor prior to the date of his report in which case he should read the 'other information' at the earliest possible opportunity thereafter to ensure that no material inconsistencies or material misstatements of facts exist.

In case the auditor comes across a material inconsistency or a material misstatement of fact, he should follow the line of action explained above.

Where the management agrees to make a revision as advised by the auditor, he should perform appropriate procedures including, if required, the issuance of a new report on the revised financial statements. Simultaneously he should also review the steps taken by the management to ensure that the individuals in receipt of the previously issued financial statements together with his report thereon and 'other information' are informed that they have been superseded.

Where the management refuses to make a revision to the financial statements which the auditor believes is necessary, he should obtain legal advice and take the steps necessary to prevent future reliance upon his report. In case of such a refusal by management, the auditor should notify the client in writing of his concern and seek legal and professional advice on what action may be appropriate. In this connection, the following observations made in the U.K. Auditing Guideline may be noted:

"If the auditor decides that he should refer to the matter in his report, he should be aware that Counsel has advised that the qualified privilege (i.e., the defence to an action for defamation) which an audit report normally enjoys may not extend to comments on:

(a) an item in the directors' report which, while not inconsistent with the financial statements, is misleading in some other respect; or

(b) financial information contained elsewhere in an annual report which is inconsistent with the financial statements or otherwise misleading."

The Guideline continues to state that the auditor may make use of his right to be heard at any annual general meeting of the members on any business of the meeting which concerns him as auditor which includes the right to draw attention to those matters described above.

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12.2.2 Post Balance Sheet Events

Post balance sheet events are defined as those events, both favourable and unfavourable, which occur between the date of the balance sheet and the date on which the financial statements are approved by the Board of directors. In more broader terms, they include events which occur between the date of the balance sheet and the date of the auditor's report.

It is true that a balance sheet is normally drawn up to reflect the financial position of an entity as at the date of such balance sheet. As such events taking place after that date cannot be expected to be dealt with in the balance sheet. However, there is one important exception to this statement - that is, unless those events are of such significance as to show that the original draft was in fact incorrect. In more clear terms, unless events occurring after the balance sheet date provide additional evidence of conditions that existed at the balance sheet date and materially affect the amounts to be included therein, they need not be reflected in the financial statements.

Classification of Post Balance Sheet Events

Post balance sheet events may be classified into two categories, viz.,

(a) adjusting events; and

(b) non-adjusting events.

(a) Adjusting events are those events which provide additional evidence relating to conditions existing at the date of the balance sheet. Such events require changes in amounts to be included in financial statements. Following are a few examples of adjusting events.

(i) The determination of purchase price or the proceeds of sale subsequent to the date of the balance sheet in respect of fixed assets purchased or sold before that date.

(ii) The receipt of a copy of the financial statements or other information in respect of an unlisted company which provides evidence of a permanent decrease in the value of a long term investment.

(iii) The receipt of evidence after the balance sheet date concerning the net realisable value of stocks, such as the receipt of proceeds of sales effected before the balance sheet date after such date indicating that the net realisable value is lower than that at which stock is stated in the financial statements, or the receipt of evidence indicating that the previous estimate of accrued profits on a long term contract was materially inaccurate.

(iv) The receipt of payments subsequent to the balance sheet date from debtors considered bad or the receipt of evidence indicating the inability of debtors considered good at the balance sheet date.

(v) The declaration of dividends by subsidiaries and associated companies which relates to the period covered by the financial statements.

(vi) The revisions in taxation rates which affect the provision for taxation.

(vii) The final judgment in respect of matters pending before Courts of Law and other authorities at the date of the balance sheet.

(viii)The receipt of information concerning the finalisation of insurance and other claims which were in the course of negotiation at the date of the balance sheet.

(ix) The receipt of evidence concerning drastic worsening in the operating results, liquidity position, etc, which will bring into question the appropriateness of going concern assumption in the preparation of financial statements.

(x) The discovery of errors, frauds and other irregularities which indicates that the financial statements were materially inaccurate.

(xi) The decisions regarding declaration of dividends, appropriation to reserves, etc.

(b) Non-adjusting events are those events taking place after the balance sheet date and concern conditions which did not exist at that date. As such they do not cause changes in the amounts included in the financial statements. Nevertheless they may be of such significance that their disclosure is necessary for the users of the financial statements to properly understand and appreciate the financial position of the entity concerned. Examples include:

(i) mergers, acquisitions and reconstructions;

(ii) new issue of shares and/or debentures;

(iii) destruction of assets by fire, flood, etc;

(iv) discontinuation of a significant part of trading activities;

(v) significant enlargement of existing trading activities or commencement of new trading activities;

(vi) fluctuations in rates of exchange, etc.

Accounting Standard (AS 4)

Accounting Standard AS 4 issued by the Institute of Chartered Accountants of India deals with the accounting and disclosure aspects in connection with events occurring after the balance sheet date. These are on the following lines :

(a) Where additional evidence is provided to assist the estimation of amounts relating to conditions existing at the balance sheet date, assets and liabilities should be adjusted for events occurring after the balance sheet date.

(b) Dividends proposed or declared in respect of the period covered by the financial statements subsequent to the balance sheet date but prior to the approval of these statements should be adjusted.

(c) In the case of events occurring after the balance sheet date which represent material changes and commitments affecting the financial position of the entity concerned, disclosure should be made in the report of the approving authority.

(d) In the case of events occurring after the balance sheet date where disclosure is required, the following additional information should be given:

  (i) the nature of the event; and

  (ii) an estimate of its financial effect, or a statement that it is not practicable to make such an estimate.

Auditor's Duties

International Auditing Guideline "The Auditor's Report on Financial Statements" states: "The report should be dated. This informs the reader that the auditor considered the effect on the financial statements and on his report of events or transactions about which he became aware that occurred up to that date." This is an indirect reminder to the auditor of his duty to perform appropriate procedures to identify and evaluate post balance sheet events of significance and to reach satisfactory conclusions as to the impact of these events on the financial statements subjected to his examination before expressing an opinion thereon. Such audit procedures are in addition to specific procedures which may be applied to transactions occurring after the balance sheet date designed to obtain evidence as to account balances at the balance sheet date, as, for example, the examination of data to ensure that transactions have been recorded in the correct period.

It goes without saying that the auditor should carry out procedures to identify post balance sheet events as near as possible to the date of his report. In general, such procedures include the following:

(a) examining the minutes of meetings of Board of directors, shareholders, and other relevant committees and enquiring about matters discussed at meetings for which minutes are not yet available;

(b) examining the client's interim financial statements, budgets, cash flow forecasts and other relevant management reports;

(c) making enquiries of the client's legal advisors concerning legal matters pending before courts of law and other authorities at the balance sheet date and which have since been decided;

(d) making enquiries of the client's management concerning events that have taken place after the balance sheet date which might affect the financial statements being subjected to the auditor's examination.

More specifically, the auditor may wish to make the following enquiries of the management*.

(a) What is the current status of the items that were included in the financial statements on the basis of tentative, preliminary or inconclusive data.

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(b) Whether any commitments have been made as, for example, by way of new borrowings or guarantees?

(c) Whether there has been any sale of assets or operating units or whether any such sale is planned?

(d) Whether there has been any new issue of shares or debentures, or any agreement of merger or liquidation, or whether any such event is planned?

(e) Whether there has been any Government action for appropriating the assets?

(f) Whether there has been any destruction to the assets, as, for example, by fire or floods?

(g) Whether there has been any significant developments relating to risk areas and contingencies known to the auditor?

(h) Whether there have been any unusual accounting adjustments since the date of the balance sheet or whether any such adjustments are contemplated?

(i) Whether management is aware of any events which have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

In case the above procedures indicate events which are likely to affect the view disclosed by the financial statements, the auditor should perform further procedures considered appropriate in the circumstances to assess whether such events are appropriately reflected in the financial statements.

Events After the Date of the Auditor's Report but Before the Financial Statements are Issued

The following observations have been made by the International Auditing Practices Committee in relation to events after the date of the auditor's report but before the financial statements are issued.

Normally the auditor has no responsibility to perform procedures to identify post balance sheet events after the date of his report. It is the responsibility of the management to inform the auditor of any events occurring in between the date of the auditor's report and the date on which the financial statements are issued, which might affect the view presented by the financial statements. Where such events come to the knowledge of the auditor, he should consider whether the financial statements need any amendment and should discuss the matter with the management. If the management is of the opinion that the statements should be amended, the auditor should carry out appropriate procedures and report on the amended statements.

Where the auditor has not yet released his report to the client and the client is not an agreement with the auditor that the financial statements should be amended, the auditor should express a qualified opinion or an adverse opinion. However, in such circumstances and where the auditor has already released his report to the client, he should notify those persons ultimately responsible for the overall direction of the entity that he will take steps to prevent future reliance on his report. The steps taken will depend on the legal rights available to the auditor and the recommendations of his legal advisors.

Discovery of Events Subsequent to the Issue of Financial Statements

Where the auditor becomes aware of certain events which will affect the view presented by the financial statements subsequent to their issue, the matter should be discussed with the management. If the management is of the opinion that the statements should be revised, the auditor should carry out appropriate procedures including the issuance of a new report on the revised financial statements. It is also important for the auditor to ensure that the client has taken steps to inform the recipients of the previously issued financial statements together with the auditor's report thereon, that they have been superseded. If the management is not in agreement with the auditor's view that the financial statements should be revised, he should notify those persons ultimately responsible for the overall direction of the entity that he will take steps to prevent future reliance on his report. The steps taken will depend on the legal rights available to the auditor and the recommendations of his legal advisors.

12.2.3 Issues of Going Concern, True and Fair View and Materiality

International Accounting Standard, 'Disclosure of Accounting Policies' issued by the International Accounting Standards Committee lays down certain generally accepted fundamental accounting concepts on the basis of which periodical financial statements of an entity are prepared. One of these fundamental accounting concepts is the 'going concern concept'. The Standard referred to above defines the 'going concern concept' as follows:

"The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations."

The interpretation of the 'going concern concept' given in AS - 1 issued by the Institute of Chartered Accountants of India is also on similar lines.

It has already been made clear that if financial statements are prepared on the basis of assumptions which differ materially from any of the fundamental concepts, the facts should be explained . In the absence of a clear statement to the contrary, there is a presumption that the going concern concept has been observed.*

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In relation to the phrase 'foreseeable future' contained in the above definition, U.K. Auditing Guideline on Going Concern states:

"While the foreseeable future must be judged in relation to specific circumstances, it should normally extend to a minimum of six months following the date of the audit report or one year after the balance sheet date, whichever period ends on the later date. It will also be necessary to take account of significant events which will or are likely to occur later."

It may be recalled in this context that while the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the management of the entity concerned. Management's responsibilities include determining whether the entity is a going concern and preparing the statements accordingly. Where the going concern is no longer appropriate, adjustments may have to be made to the values at which balance sheet assets and liabilities are recorded, to the headings under which they are classified and for possible new liabilities. For example, if the entity were to cease to be a going concern, there may be a need for reclassification of long term liabilities which become due immediately as well as provisions for amounts to be written off in respect of stocks and other assets.

As far as the auditor is concerned, he is responsible for evaluating the particular circumstances of the entity and, based on the available audit evidence, either agreeing or disagreeing with the management as to the bases upon which the financial statements have been prepared. Thus he needs to consider whether there are reasonable grounds for accepting that the financial statements should have been prepared on a going concern basis. He should, therefore, be satisfied when planning, performing and evaluating the results of his audit procedures that the going concern basis is appropriate. He should be aware that auditing procedures applied primarily for other purposes may bring to his attention information that raises doubt about the going concern assumption. Where such doubts arise, his primary consideration should relate to:

(i) the appropriate classification of assets and liabilities in the financial statements; and

(ii) the ability of the client business to realise its assets at their recorded amounts and to meet its obligations as they fall due.

The auditor will have to carry out further procedures, as described subsequently, where indications causing doubts about the client entity's ability to continue as a going concern becomes apparent. On the other hand, if no such indications are revealed during the course of carrying out audit procedures it will be reasonable for him to accept that the going concern assumption is appropriate.

Indications Raising Questions About the Going Concern Assumption

Indications raising doubts as to the ability of an entity to continue as a going concern include the following. It should clearly be understood that such indications vary

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widely in their significance, and some of them may only have significance when viewed in conjunction with others. Additionally, their significance may diminish because they are mitigated by other audit evidence. Thus the listing is not all inclusive nor does the existence of one or more factors necessarily imply always that the going concern assumption is inappropriate or should be questioned. Accordingly the auditor should consider the indications in the light of all information which comes to his attention up to the date of his audit report.

Information indicating that the client entity may not be able to meet its debts as they become due include:

(a) deficiencies in working capital;
(b) adverse key financial ratios, e.g., low liquidity ratios, over gearing in the form of high or increasing debt equity ratios, etc;
(c) excessive reliance on short term finance for long term needs;
(d) under capitalisation;
(e) financing to a considerable extent out of overdue suppliers and other creditors;
(f) substantial fixed term borrowings approaching maturity without realistic prospects of renewal or repayment;
(g) recurring operating losses.

Other indications highlighting difficulties include:

(a) arrears or discontinuance of dividends;
(b) borrowings in excess of limits imposed by debenture trust deeds;
(c) inability to pay creditors on payment due dates;
(d) difficulty in complying with loan agreements;
(e) non-compliance with capital or other statutory requirements;
(f) excessive or obsolete stocks;
(g) deterioration of relationship with bankers and other financial institutions;
(h) the continuing use of old fixed assets because of lack of funds to replace them;
(i) restrictions placed on usual trade terms including change from credit to cash-on-delivery transactions with suppliers;
(j) necessity of seeking new sources or methods of obtaining finance;
(k) potential losses on long term contracts.

There is another type of information which may indicate difficulties in the continued existence of the entity without necessarily indicating potential solvency problems. Such information might include internal matters, for example:

(a) loss of key management or operational personnel;
(b) significantly increasing stock levels;

(c) work stoppages or other labour problems;

(d) heavy reliance on the success of a particular project or on a particular asset;

(e) substantial dependence on the success of a new product;

(f) unfavourable or uneconomic long term commitments.

Alternatively, such information might include external matters, for example

(a) pending legal proceedings against the entity that may, if successful, result in judgments that could not be met;

(b) loss of a major market, franchise, license, or principal supplier;

(c) the undue influence of a market dominant competitor;

(d) shortages of important supplies;

(e) technical developments which render a key product obsolete;

(f) inability to obtain finances for necessary new product developments or other necessary investments;

(g) frequent financial failures of enterprises in the same industry.

Mitigating factors that diminish an entity's inability to continue as a going concern The auditor should consider whether the significance of factors that raise questions about an entity's ability to continue as a going concern is diminished by other audit evidence. Such audit evidence includes the ability of the management of the entity to maintain adequate cash flow by alternative means, for example,

(i) by disposing assets or postponing the replacement of assets without adversely affecting the operations of the entity;

(ii) by leasing assets rather than purchasing them outright;

(iii) by renewing or extending the due dates of existing loans, or by restructuring them;

(iv) by obtaining additional equity capital;

(v) by obtaining financial support from other group companies;

(vi) by postponing or reducing expenditure.

Similarly, the entity may be able to adopt alternative courses of action to mitigate difficulties concerning the continuation of business, for example,

(i) by finding alternative sales markets when a principal customer is lost;

(ii) by making available suitable personnel to fill key positions;

(iii) by making use of alternative resources;

(iv) by operating the business at reduced levels; etc.

Methods of Obtaining Audit Evidence — Audit Procedures

During the course of carrying out normal audit procedures it is usual for the auditor to come across indications concerning the difficulties encountered by the client entity to continue as a going concern. When questions arise as to the ability of the entity to continue as a going concern, some of these procedures may take on additional significance. In this context the auditor will be particularly concerned with interim accounts or management information, and consulting with the management and staff of the entity. Such consultations should cover both the current situation and the future. In case there exist formal forecast and budget systems these should be considered. In case these are not formalised, discussions with the management should cover management's outline plans, including a comparison of anticipated needs with borrowing facilities and plans.

Considerations as above should be continued up to the date of the audit report. At the same time, it is important that early identification of going concern problems will give the management more time to consider their response and to obtain suitable professional advice.

In case the results of the procedures as above indicate that the client business may be unable to continue as a going concern, the auditor should review any factors that may mitigate those indications. Such a review should, inter alia, include the following:

(a) Initiate further discussions with the management. Find out whether the management has developed plans to overcome the difficulties. In case the management has done so, consider the bases on which they have been prepared. Obtain written confirmations from financial institutions and other third parties in order to make sure about their commitment in providing appropriate support.

(b) Consider any professional advice obtained by the management as to the extent of the difficulties faced by the client business and the practicalities of overcoming them.

(c) Review the events after the balance sheet date for items affecting the entity's ability to continue as a going concern.

(d) Read minutes of meetings of shareholders, Board of directors and other relevant committees for reference to financing difficulties.

(e) Request information on any significant legal matters from the client entity's legal advisors.

(f) Perform the following procedures where the client business is a member of a group and where the management expects support from other members of the group:

   (i) consider the implications of any obligations, undertakings or guarantees existing between the client business and other group members;

   (ii) obtain legal advice to understand properly the details of any agreements between the group members;

   (iii) judge whether it is possible that, in the event support becomes necessary, it will be forth coming;

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(iv) as an extension to (iii) above, consider whether the agreements are *prima facie* legally binding or are merely expressions of intent, whether they have been formally approved and minuted, and whether the supporting group member is in a position to provide support;

(v) examine the financial statements of other group members and, wherever appropriate, consult their auditors.

The above procedures are also applicable where the client entity expects support from another entity, even if no group relations exist.

Effect on the Auditor's Report

After considering the results of the procedures referred to above, the auditor should determine whether he has obtained sufficient appropriate audit evidence concerning the ability of the client entity to continue as a going concern. Where he is satisfied that he has obtained such evidence he should express an unqualified opinion.

If the auditor believes that there are substantial doubts about the ability of the entity to continue as a going concern, and the going concern basis is used in the preparation of the financial statements, he should consider the recoverability and classification of assets, the classification of liabilities and the possibility of new liabilities in the event the entity is unable to continue as a going concern. For example, there may be a need for provisions or amounts to be written off in respect of stocks and debtors, reclassification of long term liabilities which become due immediately, provisions in respect of redundancy payments and revaluation of assets at their market values. While it will not normally be practicable to quantify precisely the extent of the adjustments that would be necessary where the financial statements not to be prepared on a going concern basis, the auditor should form an opinion as to their likely impact on the financial statements.

If the auditor concludes that the potential impact of the going concern uncertainty on the financial statements is not material, he should express an unqualified opinion.

If the auditor considers that the uncertainty as to the appropriateness of the going concern assumption materially affects the view given by the financial statements, he should qualify his report by expressing a 'subject to' opinion (qualified opinion). Materiality should be judged in terms of the extent of the adjustments that would need to be made to the financial statements in the event that they were not to be prepared on a going concern basis. The report should refer to the going concern assumption upon which the financial statements have been prepared, the nature of the related uncertainty and the nature of the adjustments that may have to be made to the financial statements.

An explanatory paragraph on the following lines has been given as an illustration by the U.K. Auditing Guideline, where the auditor encounters a situation as mentioned in the above paragraph:

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"The financial statements have been prepared on a going concern basis. The basis may not be appropriate because the company incurred a loss after taxation of...during the year ended 31st December ...and at that date its current liabilities exceeded its current assets by ...Further the company is currently negotiating for long term facilities to replace the loan of ...which is repayable on ...These factors, indicate that the company may be unable to continue trading.

Should the company be unable to continue trading, adjustments would have to be made to reduce the value of assets to their recoverable amount, to provide for any further liabilities which might arise, and to reclassify fixed assets and long term liabilities as current assets and current liabilities.

Subject to the company being able to continue trading in our opinion ..."

(The assumptions in the above example concerning the circumstances giving rise to the uncertainty were that the company was loss making, current liabilities exceeded current assets, negotiations about vital financial arrangements had not been successfully completed at the date of the audit report, adequate disclosure of these facts had been made in the notes to the financial statements, and adjustments would be needed to the financial statements were they not to be prepared on a going concern basis.)

Another example given by the International Auditing Practices Committee to illustrate an auditor's qualified report includes the following paragraph as the Explanatory Paragraph:

"As shown in the financial statements, the company incurred a net loss of ...during the year ended 31st December ...and, as of that date, the company's current liabilities exceeded its current assets by ...These factors, along with matters as set forth in the notes to the financial statements, raise substantial doubt that the company will be able to continue as a going concern. The financial statements do not include any adjustments relating to the recoverability and classification of recorded assets the amounts and classification of liabilities that might be necessary should the company be unable to continue as a going concern."

The Opinion Paragraph should be so worded as to include the following:

Subject to the effects of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, in our opinion and to the best of information and according to the explanations given to us, the financial statements together with the schedules attached and read with notes, give a true and fair view -

(i) In the case of the Balance Sheet ...

In addition, where the auditor is of the opinion that management's disclosure of the going concern situation is not satisfactory, he should further qualify his report with respect to the inadequacy of disclosure in the financial statements.

If the auditor concludes that the appropriateness of the going concern assumption is so fundamental as to prevent him from forming an opinion on the financial statements, he should express a disclaimer of opinion.

True And Fair View

As explained earlier, the Companies Act, inter alia, imposes a duty upon the auditor to report whether the financial statements subjected to his examination show "true and fair view". The Act, however, does not define what exactly is meant by the expression "true and fair view" nor is it possible to explain it in a few words.

The financial statements of an entity contain information which quantifies in monetary terms the business activity arising from the utilisation of the entity's resources. When the auditor reports that the financial statements show a "true and fair view" it implies that these statements represent as closest as possible to reality the actual financial position of the entity as at the end of the defined accounting period and the operating results for that particular period. 'Truth and fairness' thus does not mean absolute accuracy but is more concerned with giving a view of the entity and its operations that will enable the users of the financial statements to make any valid decision or conclusion.

The following general principles, it is hoped, may act as useful guidelines in judging the 'truth and fairness' contained in the financial statements. It must be remembered in this connection that what follow are only broad guidelines and as in many instances the auditor should exercise his own commercial judgment in the light of all surrounding circumstances before a final view is formed as to the 'truth and fairness' contained in the financial statements concerned.

1. The business activity of an entity forms the basis of the quantification process for producing financial accounting data of use in the preparation of its periodic financial statements. This quantification process involves a series of tasks like properly recognise, calculate, classify, post, summarise and report transactions. It is necessary for the auditor to review this quantification process through its various stages of documentation, recording, collation, etc in order to verify the accuracy of the data which are eventually used for the preparation of financial statements. It follows that one of the most important factors to be considered in this connection is to make sure that the entity has maintained proper books of account which means such books as are necessary to properly document, record and collate the quantification of the daily business activities of the entity and to explain its transactions. If, for example,
    (a) the accounts of the entity are seriously and consistently in arrears in that postings and other routine transactions are not entered in the books reasonably promptly; or

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(b) the data contained in the financial records are found to be, in part, or in total, inaccurate because incorrect money values have been attributed; or

(c) interim accounts are not available to indicate to the management whether the entity is operating at a profit or loss; or

(d) the cost accounts are inadequate to enable the management to attribute a proper amount to the work in progress and finished stock which is carried forward in the financial statements;

Then the entity cannot be considered as having kept 'proper books of account' reflecting the relevant financial accounting data. The financial statements prepared from such incomplete and inaccurate data cannot be considered as satisfying the required standards of 'truth and fairness'.

2. The existence of an efficient system of internal control and its effective operation in an uninterrupted manner throughout the accounting period are necessary prerequisites for achieving the concept of 'truth and fairness' of accounting information. As observed at an earlier context:

   "the system of internal control is the plan of organisation and all the methods and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."

   The client's system of internal control can have a significant bearing on the 'truth and fairness' of accounting information in that a study and evaluation of the entity's system of internal control will highlight whether it is capable of providing a reasonable assurance that the accounting system is adequate, that transactions are properly recorded in the accounting records during the period for which they relate and that significant transactions have not been omitted. On the other hand, where the entity's system of internal control is such as to cast doubts on the reliability of financial records, it will not be possible to satisfy whether the financial statements show a 'true and fair view'.

3. The culminating point in the processing of financial accounting data is the production of financial statements summarising the past business activities of the entity concerned. As observed by Tom Lee:

   "The financial accounting information produced from processed data, and communicated to the shareholders and other users of company financial reports, must achieve the required standards of truth and fairness if it is to obtain an unqualified opinion from the auditors - that is, it must correspond to the business transactions, etc, it purports to describe, being positively traceable and significantly connected to the latter; be objective, being free of any bias which could be detrimental to the interests and needs of the shareholders (and also, ideally, of other users of financial statements), and be based on unprejudiced and verifiable evidence which is capable of supporting it."

In short, the auditor should be satisfied that -

(i) all relevant Accounting Standards issued by the concerned professional bodies have been complied with except, in situations in which for justifiable reasons they are not strictly applicable because they are impracticable, or, having regard to the circumstances, would be inappropriate or give a misleading view, in which case adequate disclosures are made so that the users may be aware of such deviations;

(ii) any significant accounting policies which are not the object of Accounting Standards but are appropriate to the circumstances of the business.

In more clear terms, the financial statements should satisfy the following in order to disclose a "true and fair view".

(a) They should be prepared using acceptable accounting policies, appropriate to the circumstances and nature of the business.

(b) Once selected as appropriate, these accounting policies should be applied consistently and the effect of any change should be adequately explained and disclosed.

(c) They should be prepared on the basis of generally accepted basic assumptions and the effects of any departure should be adequately explained and disclosed.

(d) They should comply with relevant regulations and statutory requirements.

(e) The view presented by them as a whole should be consistent with the auditor's knowledge of the business of the entity.

(f) There should be adequate disclosure of all material matters relevant to their proper presentation. Such matters should cover information, though not specifically detailed in the Statute, which is necessary for the users of such financial statements, e.g., all unusual, exceptional or non-recurring items should be disclosed separately.

(g) Additional information given in a note or other documents forming part of the financial statements, should not materially alter the view otherwise given in the financial statements.

Materiality

A term which is frequently used in connection with audit is "materiality". For instance, as explained earlier, an auditor may not be able to express an unqualified opinion when certain circumstances exist and, in the auditor's judgment the effect of the matter is or may be "material" to the financial statements. Questions of materiality arise in relation to the preparation of any types of accounts, both statutory and non-statutory, where the object is to present a 'true and fair view' of the results for a period or the position as at a particular date.

At the very outset it may be made clear that it is not possible to confine the interpretation of the term "material" to a simple and precise definition. Its interpretation is a matter for the exercise of professional judgment based on experience and the requirement to give a true and fair view. In other words, judgment of materiality is subjective and must be based upon an awareness of the particular circumstances and with due regard to the needs of the users of financial statements. In general terms it may be stated that a matter becomes material when its non-disclosure, misstatement or omission would be likely to distort the view shown by the financial statements. To put it in another way, a matter becomes material when knowledge of that matter would be likely to influence the users of the financial statements.

Broadly it may be stated that two closely related factors are to be considered in judging the materiality of an item, viz.,

(i) nature or characteristics of the item concerned; and

(ii) its amount.

The nature of the item requires considerations such as the degree of subjectivity inherent in it and any statutory requirements. For instance, there are certain items where the amount at issue is arrived at on the basis of certain assumptions and exercise of judgment. Provision for depreciation is a typical example. In such cases some measure of arbitrary assessment is inherent in determining the amount to be written off in any year. A margin of error which is high in relation to the item itself might be acceptable, if it is acceptable when viewed in the context of profit and of the associated balance sheet items.

The degree of estimation or approximation which is unavoidably inherent in arriving at the amount of an item may also be a factor in deciding on materiality. Stock valuations and tax provisions are examples.

In contrast, items such as share capital, directors' emoluments, audit fees and investment income have a particular interest or importance to shareholders, so that an error which might be insignificant in the general context, and indeed may not be large in relation to the item itself, might nevertheless be considered material. These items are normally capable of precise measurement. Also, statutory requirements for disclosure inhibit any latitude in respect of them. In short, it may be stated generally that for items where precision is both desirable and achievable and where statutory requirements for disclosure inhibit any latitude, any departure from the exact figures would call for no justification.

It may be noted in this connection that an item may be material in either a general or a particular context. The general context refers to the true and fair view by the financial statements as a whole. The particular context refers to the total of which an item forms or should form part and any directly associated items. In case an item is material in the general context, the degree of latitude acceptable in the particular context will normally depend upon its nature on the lines suggested above.

In considering the amount of the item it is usually expressed as a percentage against some base figure. The base figure would usually be a typical operating profit for profit and loss account items and the lower of share capital and reserves or the balance sheet class total for balance sheet items. When the item is more than ten per cent of the appropriate base figure it should be considered material; between five per cent and ten per cent it would be a matter of judgment.

It may be mentioned here that the use of Profit figure as a point of comparison tends to be vitiated when the profits are abnormally low or where there is a loss. While judging materiality of individual items in the Profit and Loss account in such cases, the more normal dimensions of the business have to be considered.

It is equally important to be careful before offsetting or aggregating items. It is quite possible that two items, which might each be material when taken separately, will be of opposite effect when taken together. Careful consideration should be given before offsetting such items. For instance, a profit arising as a result of a change in the basis of accounting should not be offset against a non recurring loss. Similarly, where there are a number of small items, it may be necessary for them to be aggregated to ascertain if they are material in total.

Check Your Progress

1. What is the other information issued with the audit financial statements?
2. List examples of non-adjusting events.
3. In what terms is materiality judged?

12.3 AUDIT PROCEDURES FOR SPECIAL INSTITUTIONS

In this section you will learn about the procedures involved in auditing of club, hotels, hospital and cinema.

12.3.1 Audit of Club

When auditing social clubs, the auditor is faced with certain problems. Clubs are managed largely by volunteers who lack professionalism. The small size of managerial staff and its voluntary nature make the division of duties difficult. The sources of cash are numerous and varied. Of course, it is comparatively easy to control subscription and joining fees. But cash may be forthcoming from other sources also such as social functions, hire of the facilities of the club, canteens and bars, local authority subsidies and grants, etc. Further, unusual and non-recurring receipts of cash are likely to be there. The club authorities should be advised to make use of an analytical cash book so that each source of income could be identified. Banking cash and regular counts of cash will also enhance the control over cash.

Items of expenditure, particularly those expenses that are paid in cash from receipts, also pose problems. Where payments are made for such items as casual labour, it is extremely difficult to verify them unless the receipts are properly controlled. It would be advisable to ensure that all invoices or all items of cash expenditure are authorized by the head of the relevant committees or by someone other than the person handling cash. In addition, control over expenditure could be enhanced if there are two signatories for all cheques and by insisting that cheques are signed only with supporting documentation.

'Stocks' is another area that gives rise to difficulties. The extent of these difficulties depends on the stock lines and the accuracy of the analysis of cash and purchases. As far as possible, it should be ensured that stocks are controlled by regular stocktaking.

The following general procedures may be followed in carrying out an audit of a social club.

1. Examine the bye-laws of the club in order to ascertain its legal status, the power of its executive committee, and the rules and regulations concerning its accounts in general and the opening and operation of bank account in particular.
2. Examine the relevant minutes with particular reference to matters affecting the accounts.
3. Vouch the joining fees and annual subscription together with the counterfoils of the receipt books. The total should be verified with the annual list of members. Amounts shown as arrears should be enquired into.
4. Make sure that proper appropriation is made of life membership fees, subscription in arrears and subscription received in advance.
5. Vouch cash received from social functions, hire of the facilities of the club, canteens, bars, etc. and make sure that there is proper control over such cash receipts.
6. Unusual and non-recurring receipts of cash should receive the attention of the auditor. Ensure that they are properly apportioned.
7. Make sure that expenditure is incurred only on proper authorization according to the rules and regulations of the club. Examine the

supporting documentation and ascertain the accuracy of apportionment between capital and revenue.

8. Verify in the usual manner the assets and liabilities of the club as at the date of the balance sheet, giving due consideration to stock in hand.

In order to give a clean opinion, the auditor must be satisfied with the club's internal control system. Otherwise, the auditor will be forced to express in his report his dissatisfaction with material inadequacies. Usually while auditing clubs, the auditor places emphasis on substantive testing and analytical review procedures rather than compliance testing.

12.3.2 Audit of Hotels

Audit objectives in the case of hotels are: (i) to ensure that all billable services are correctly reported and properly reflected in the financial statements, (ii) to ascertain that adjustments to revenue are appropriate and approved, (iii) to ensure that procedures and policies of the entity concerning revenue recording and reporting are carried out in accordance with current requirements, and (iv) to ascertain that controls and procedures are efficient, effective and economical.

1. Examine the constitution of the hotel with particular reference to its legal status, the rules and regulations concerning the maintenance of accounts in general and operation of bank account in particular.
2. See whether the hotel is affiliated to any chain of hotels. The terms of affiliation should be examined and it should be ensured that they are complied with.
3. Examine the internal control system in operations as regards (a) purchases (including edibles, stores, kitchen, guest toiletries), (b) occupancy of rooms, etc, (c) procedures for taking orders, serving food and collection of bills, (d) recording sales, (e) salaries of staff, (f) registration of guests, recording of check in time, number of persons differentiating between adults and children etc., (g) serving food inside the rooms, (h) booking of conference hall, (i) discarding (or, otherwise disposing) furniture, cutlery, etc. (j) facilities such as foreign exchange conversion, travel desk, shopping area, etc.
4. Evaluate ICQs (internal control questionnaire) for weaknesses.
5. Study significant accounting and other policies of the hotel with reference to check-in and check-out time of the guests, discount structure, concessions to corporate clientele, allocation of overheads to various departments or profit centres, etc.
6. Get an understanding of the various profit centres identified by the management of the hotel.
7. Arrive at the gross profit for each profit centre and make use of analytical review procedures in order to make comparisons with industry averages and previous year's figures which will give an insight into the reliability of the figure for the current year.

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8. Examine the allocation of overheads such as depreciation on furniture, kitchen equipments to the profit centre concerned.
9. Understand the procedures for collection through credit cards and see that they are followed.
10. Vouch receipts (such as room revenue, food and beverages, banquets, etc.) and payments (such as administrative expenditure, purchases, etc.) and ensure that there is proper control over them.
11. Vouchers should be obtained for all revenue adjustment transactions for a couple of test days selected during pre-audit. Total voucher amount should be traced to final revenue detail report to ascertain whether all adjustments are supported by proper vouchers. Review vouchers for propriety, proper completion and approval.
12. Vacant room inspection procedures should be documented, showing (i) whether all rooms not reporting revenue are inspected daily, (ii) what report is used for the inspection, (iii) who performs the inspection, (iv) how is the inspection documented, etc.
13. Review lease/rental agreements for hotel space to ascertain whether recorded revenues agree to the terms specified.
14. In the case of entity managed gift shops: (i) discuss with the management procedures to verify that all gift shop revenues are correctly recorded and ensure whether an inventory count is performed periodically by management, and (ii) on the basis of profit and loss review, evaluate gift shop profit margin for reasonableness as compared to budget.
15. See whether a separate account is maintained for special events like food festivals and that the surplus is transferred to general profit and loss account.
16. Ensure that depreciation, interest on loans, auditor's fee, etc. are charged to the general revenue account to arrive at the profit or loss.
17. In case interest is paid out of capital (hotels are considered to be long gestation projects), ensure that the requirements of the Companies Act are complied with.
18. The Companies Act requires the auditor to state whether there is a periodic verification of fixed assets and the treatment of material variations observed during the course of such verifications.
19. Obtain a management letter of representation for the verification of miscellaneous assets like crockery and cutlery.
20. Check all bills raised on licencees with reference to agreements including charge of electricity wherever applicable.
21. Review various insurance covers taken for their adequacy.
22. Review insurance claims lodged with the insurance companies and follow up action.

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23. Review position of maintenance of books of accounts and make suggestions, if any, for updating.
24. Review bank reconciliation statements.
25. Review advances and their adjustments.
26. Review outstanding liabilities for adjustments.
27. Scrutinize general ledger for required adjustments.

12.3.3 Audit of Hospitals and Nursing Homes

Auditing of hospitals and nursing homes requires following of strict procedures and guidelines as these are community welfare institutions. Following are some of the salient features of hospital audits.

1. Examine the relevant provisions binding the formation and organization of the entity with particular reference to the maintenance of accounts.
2. Check cash received in respect of various services recorded in the relevant registers along with the counterfoils of receipt books and any other documentary evidence.
3. Check the receipts on account of subscriptions, donations, etc. in the cash book with reference to all documentary evidences such as counterfoils of the receipt books, correspondence, etc. If they are made for a specific purpose, ensure that it is complied with.
4. Vouch any grants received from the Government or local authorities along with the relevant correspondence and ensure that such grants are utilized properly.
5. Follow the usual procedures in vouching miscellaneous receipts such as rent, interest, dividends, etc. Ensure that tax paid, if any, on the same is reclaimed in case of exemptions.
6. Ensure that expenses are incurred on proper authorization and in accordance with budget sanctions.
7. Ensure that a proper system of internal checks exists concerning the receipt and issue of medicines, equipments, linen, etc.
8. Ensure that the items included in stock at the balance sheet date are valued properly, comparing the total value with the relevant ledger balances.
9. Verify in the usual way the fixed assets of the entity and ensure that adequate depreciation has been provided on them.

12.3.4 Audit of Cinema

The object of cinema halls and their business is providing the general public entertainment through the exhibition of movies. But the activities at cinema halls are not limited to the showing of movies but also include other allied activities including restaurant and bars, gaming facilities etc. The sources of revenue of cinema

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halls come activities like ticket sales, exhibition of movies, advertisements, rental income as well as income from sale of food and beverages.

Therefore, the following are the receipts that need to be checked by the auditor:

i. Cash from ticket sales
ii. Fees from advertisers
iii. Receipts from lease rents of third-party vendors as well as cinema distributors
iv. Receipts from sale of food and beverages

Let's discuss each of these heads in detail here:

i. Auditing of Sale of Tickets involve

- Ensure the seriality of numbering of tickets
- Check that same class tickets are issued serially at all times consistently
- Check whether entries to shows are not without tickets
- Check whether advance booking tickets are numbered differently in serial order
- Verify the preparation of statements for daily sale of tickets and vouched through cash book entries
- Check whether unsold ticket stocks are prepared and entertainment tax on each paid
- Check the authenticity of free or complementary tickets and due process followed for their authorization

ii. Auditing of Receipts through Advertisements

- Verifying the contract and agreements with advertisers
- Vouching of collections from advertisements
- Checking expenditures on advertisements
- Check treatments under deferred revenue expenditures

iii. Auditing of payments to distributors

- Check term of agreement with distributors
- Vouch payments against bills raised
- Verify adjustments related to advances paid and returns made to them after the showing
- Check whether provisions for long term payments and money irrecoverable made properly

iv. Auditing of collections from sale of food and beverages

- Check the terms of operations whether run by the cinema itself or third party
- Verify sale and purchase of different items
- Check the internal system controls of these restaurants

Check Your Progress

4. Which types of testing are given emphasis in auditing of clubs?
5. What needs to be checked in case of audit of entity managed gift shops?
6. List the categories of receipts in case of cinema halls.

12.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. 'Other Information' referred to in the heading includes such financial and non-financial information. Examples of 'other information' include Chairman's statement, a report by management or Board of directors on operation, financial summaries or highlights, employment data, planned capital expenditure, financial ratios, etc.
2. Examples of non-adjusting events include:
   (i) mergers, acquisitions and reconstructions;
   (ii) new issue of shares and/or debentures;
   (iii) destruction of assets by fire, flood, etc;
   (iv) discontinuation of a significant part of trading activities;
   (v) significant enlargement of existing trading activities or commencement of new trading activities;
   (vi) fluctuations in rates of exchange, etc.
3. Materiality should be judged in terms of the extent of the adjustments that would need to be made to the financial statements in the event that they were not to be prepared on a going concern basis.
4. While auditing clubs, the auditor places emphasis on substantive testing and analytical review procedures rather than compliance testing.
5. In the case of entity managed gift shops: (i) discuss with the management procedures to verify that all gift shop revenues are correctly recorded and ensure whether an inventory count is performed periodically by management, and (ii) on the basis of profit and loss review, evaluate gift ship profit and loss review, evaluate gift ship profit margin for reasonable as compared to budget.

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6. The receipts that need to be checked by the auditor:
    - Cash from ticket sales
    - Fees from advertisers
    - Receipts from lease rents of third-party vendors as well as cinema distributors
    - Receipts from sale of food and beverages

12.6 SUMMARY

- It is usual for a business enterprise to issue on an annual basis a document referred to as the “annual report” which includes its financial statements together with the audit report. In issuing such a document, the enterprise may include, either by law or custom, in addition to the audited financial statements, other financial and non-financial information.
- ‘Other Information’ referred to in the heading includes such financial and non-financial information. Examples of ‘other information’ include Chairman’s statement, a report by management or Board of directors on operation, financial summaries or highlights, employment data, planned capital expenditure, financial ratios, etc.
- The auditor should make appropriate arrangements with his client to obtain ‘other information’ included in the annual report prior to the date of his report. While the auditor has no responsibilities to perform audit procedures to determine that such ‘other information’ is properly stated, he should read the ‘other information’ to determine that it is not materially inconsistent with the financial statements. During the course of doing so, the auditor may become aware of any material misstatement of fact.
- Unless events occurring after the balance sheet date provide additional evidence of conditions that existed at the balance sheet date and materially affect the amounts to be included therein, they need not be reflected in the financial statements.
- Post balance sheet events may be classified into two categories, viz.,
    (a) adjusting events; and
    (b) non-adjusting events
- The auditor has duty to perform appropriate procedures to identify and evaluate post balance sheet events of significance and to reach satisfactory conclusions as to the impact of these events on the financial statements subjected to his examination before expressing an opinion thereon. Such audit procedures are in addition to specific procedures which may be applied to transactions occurring after the balance sheet date designed to obtain evidence as to account balances at the balance sheet date.

- The auditor is concerned, he is responsible for evaluating the particular circumstances of the entity and, based on the available audit evidence, either agreeing or disagreeing with the management as to the bases upon which the financial statements have been prepared. Thus he needs to consider whether there are reasonable grounds for accepting that the financial statements should have been prepared on a going concern basis.
- The financial statements of an entity contain information which quantifies in monetary terms the business activity arising from the utilisation of the entity's resources. When the auditor reports that the financial statements show a "true and fair view" it implies that these statements represent as closest as possible to reality the actual financial position of the entity as at the end of the defined accounting period and the operating results for that particular period.
- Questions of materiality arise in relation to the preparation of any types of accounts, both statutory and non-statutory, where the object is to present a 'true and fair view' of the results for a period or the position as at a particular date.
- When auditing social clubs, the auditor is faced with certain problems including that of management, sources of cash, unusual and non-recurring receipts, items of expenditure, stocks, etc.
- General procedures of auditing of social club should include checking of bye laws, relevant minutes, joining and other fees, vouch cash received, unusual receipts, authorization of expenditure incurred, assets and liabilities, etc.
- Auditing of hotels involve checking of constitution of the hotel, internal control system, its affiliations, profit centres, allocation of overheads, vouchers of receipts and payments, bills, lease/rental agreements, etc.
- Auditing of hospitals and nursing homes include checking of conditions related to the formation and organization of the entity, cash received, grants, treatment of miscellaneous receipts, expenses incurred, system of internal checks, items in the balance sheet, etc.
- The object of cinema halls and their business is providing the general public entertainment through the exhibition of movies. But the activities at cinema halls are not limited to the showing of movies but also include other allied activities including restaurant and bars, gaming facilities etc.
- The following are the receipts that need to be checked by the auditor:
    - o Cash from ticket sales
    - o Fees from advertisers

- o Receipts from lease rents of third-party vendors as well as cinema distributors
- o Receipts from sale of food and beverages

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12.7 KEY WORDS

- **Post balance sheet events:** These are defined as those events, both favourable and unfavourable, which occur between the date of the balance sheet and the date on which the financial statements are approved by the Board of directors.
- **Going concern:** It is an accounting concept in which the 'enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future.'

12.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on other information issued with audited financial statements.
2. How are events after the date of the auditor's report but before the financial statements are issued treated?
3. List the indications raising questions about the going concern assumption.
4. How is materiality defined and understood in the context of auditing?
5. Write a short note on the problems of auditing social clubs.
6. What are the audit objectives in case of hotels?
7. Briefly explain the auditing of hospitals and nursing homes.
8. Write a short note on the auditing of cinema halls.

Long Answer Questions

1. What are the categories of post balance sheet events? State the auditor's duties regarding these.
2. Describe the general principles which may act as useful guidelines in judging the 'truth and fairness' contained in the financial statements.
3. Discuss procedures involved in audit of hotels.

12.9 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

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UNIT 13 LIABILITIES AND QUALITIES OF AN AUDITOR

Structure

13.0 Introduction
13.1 Objectives
13.2 Liabilities of an Auditor: Professional Negligence, Damages and Civil Liabilities
13.3 Professional Ethics and Qualities of Good Auditor
13.4 Professional Misconduct of Statutory Auditor
13.5 Procedure for Enquiry
13.6 Answers to Check Your Progress Questions
13.7 Summary
13.8 Key Words
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13.0 INTRODUCTION

Does an auditor always act with integrity? While it is expected of him, there are chances that there might be problems related to the work of the appointed auditor whether intentional or not. There are many provisions laid by different laws covering such aspects as the liabilities of an auditor, professional misconduct, and procedure for enquiry. Such provisions ensure that there is a proper way of dealing with such cases and appropriate punishments defined. In this unit, you will learn about the provisions related to the liabilities of an auditor, the acts which constitute as professional misconduct and the procedures for enquiry. This unit will also discuss the general professional quality and ethics which are expected of an auditor.

13.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the provisions related to the liabilities of an auditor
- Discuss the professional qualities and ethics of an auditor
- Describe the various acts of professional misconduct
- Examine the procedure for enquiry

13.2 LIABILITIES OF AN AUDITOR: PROFESSIONAL NEGLIGENCE, DAMAGES AND CIVIL LIABILITIES

Liabilities of auditors, in their professional capacity, arise mainly from the following sources, namely:

(a) Liabilities under the Contract Act

(b) Liabilities under the relevant statute, e.g., the Companies Act and/or the Penal Code, the Income Tax Act, the Chartered Accountants Act, etc

Liabilities under the Companies Act may again be sub divided into civil liability and criminal liability. In the case of a private audit, the liabilities of an auditor are mainly dependent on the terms of his engagement.

Liability for Professional Negligence

Liability for professional negligence arises irrespective of whether it is a private audit or a company/statutory audit. It is a common rule of law that a person who owes a duty to another is expected to act without negligence when the former discharges his duty to the latter. In the case of an accountant, he is expected to act with 'reasonable care and skill' while discharging his duties. What is 'reasonable care and skill' depends on the particular circumstances of each case. Nevertheless, this phrase certainly implies that the accountant/auditor has to carry out his work in accordance with the generally accepted accounting/auditing standards issued by the professional bodies from time to time and that it should be in step with contemporary accounting/auditing practices.

While considering any charge of dereliction of duty or negligence, the courts of law is almost certain to judge the merits of the case by reference to the criteria of 'reasonable care and skill'. In this connection it should be remembered that what exactly constitutes 'reasonable care and skill' is subject to change, in step with changes in legislation and standards of professional work in general. In these times of litigation consciousness, accountants/auditors in general are well aware of the liability that they may have to face in case a charge of negligence is levelled against them. The best way to counter these charges is for the accountant/auditor to satisfy himself concerning the scope and quality of the work they have carried out and that the work is in conformity with the requirements of 'best practice'.

Penalty for Non-Compliance by Auditor with Sections of the Compaines Act

Section 147 lays down the provisions related to the contravention of the provisions related to Audits and Auditors as mentioned in Chapter 10 of the Companies Act 2013.

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1. If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees.
2. If an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees or four times the remuneration of the auditor, whichever is less

   Provided that if an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees or eight times the remuneration of the auditor, whichever is less
3. Where an auditor has been convicted under sub-section (2), he shall be liable to—
   a. refund the remuneration received by him to the company; and

   (ii) pay for damages to the company, statutory bodies or authorities or to members or creditors of the company for loss arising out of incorrect or misleading statements of particulars made in his audit report.
4. The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.
5. Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally

   Provided that in case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.

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Criminal Liability

In considering the criminal liability of an accountant/auditor, the relevant provision in the Income Tax Act is of relevance. In terms of the Income Tax Act, an authorized representative (which includes an accountant/auditor) who is found guilty of abetting or inducing an assessee in filing a false account, statement or declaration which he knows to be false or does not believe to be true is criminally liable. According to the relevant provision –

> "If a person abets or induces in any manner another person to make and deliver an account or a statement or a declaration relating to any income chargeable to tax which is false and which he either knows to be false or does not believe to be true or to commit an offence under sub-section (i) of section 276 C, he shall be punishable:
>
> (i) in a case where the amount of tax, penalty or interest, which would have been evaded, if the declaration, account or statement had been accepted as true, or which is willfully attempted to be evaded, exceeds one hundred thousand rupees with rigorous imprisonment for a term which shall not be less than six months but which may extend to seven years and with fine;
>
> (ii) in any other case, with rigorous imprisonment for a term which shall not be less than three months but which may extend to three years and with fine."

The Indian Penal Code also contains a provision relating to the issue of false certificates which is of relevance to accountants/auditors. According to the relevant provision:

> "Whoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, shall be punishable in the same manner as if he gives a false evidence."

With particular reference to limited companies, sections 31 and 448 of the Indian Companies Act are of relevance.

13.3 PROFESSIONAL ETHICS AND QUALITIES OF GOOD AUDITOR

A code of professional ethics is a necessary pre-requisite for the success of the accountancy profession. Chartered accountants who attest the financial statements of organizations have certain responsibilities and obligations towards those who rely on their work. According to the International Federation of Accountants, 'Persons who pursue a vocation in which they offer their knowledge and skills in the service of the affairs of others have responsibilities and obligations to those who rely on their work. An essential pre-requisite for any group of such persons is the acceptance and observance of professional ethical standards regulating their relationship with clients, employers, employees, fellow members of the group and the public.'

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The Code of Ethics requires that the objectives of accountancy profession are to set the highest standards of professionalism, to attain the highest level of performance, and generally to meet the public interest requirements. Four basic needs are involved in these objectives, viz., credibility, professionalism, quality of service and confidence. With a view to achieving these objectives, chartered accountants in service have to display the following qualities:

Professional competence: An audit should be carried out and the audit report should be prepared only by persons who have adequate training, experience and competence in auditing. And the auditor should be careful to exercise due skill and professional care throughout his work. What is 'due skill and professional care' will depend on the circumstances of each particular case. So also the extent of training, experience and competence required of audit assistants will depend on the gradations and functions of work carried out by them. It need hardly be emphasized that specialized skills and competence are required of an auditor. These are acquired through a combination of general education, technical knowledge obtained through study and formal courses concluded by a qualifying examination, and practical experience under proper guidance and adequate supervision. It is of utmost importance that an auditor should refrain from undertaking or continuing any audit assignment which he is not competent to carry out unless he obtains such advice and guidance as will enable him to carry out his assignment successfully.

Knowledge of current developments: It is equally important that an auditor should have a continuing awareness of developments including relevant national and international pronouncements in the fields of accounting and auditing, and relevant regulations and statutory requirements. This will ensure that his client receives the advantage of competent professional advice based on up-to-date developments in practice, legislation and techniques.

Integrity and objectivity: Integrity and objectivity are pre-eminent qualities expected in all auditors. An auditor should be straightforward, honest and sincere in his approach to professional work.

Fairness: An auditor must be fair and should not allow prejudice or bias to override his objectivity. He should ensure that he maintains an impartial attitude while he is reporting on the financial statements subjected to his examination. He should both be and appear to be independent of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. In other words, an auditor should be, and seen to be, independent in each professional assignment he undertakes of any interest which might detract him from objectivity.

Non-biased and independent: An auditor must approach his work with an independent attitude. He should not do anything that would adversely affect that independence. As a matter of fact, independence is an essential concomitant to integrity and objectivity in an auditor. It is the quality which permits the auditor to apply unbiased judgment and objective consideration to established facts in arriving at an opinion. In considering situations that may come into conflict with an auditor's independence, the following matters are important. (i) Financial involvement, direct or indirect, in a client's affairs, e.g., in the case of a limited company being in the position of a shareholder, loans to or from clients, etc. (ii) Cases where an auditor or a firm of auditors earn the major part of their professional income from one client or a group of connected clients. (iii) Personal and family relations. For instance where the same partner or member of staff is in charge of the audit of a particular client for a number of years; where the auditor has a mutual business interest with an officer or employee of a client; where the auditor has an interest in a joint venture; close friendship or relationship by blood or marriage; etc. (iv) Acceptance of audit assignments on a contingent fee basis.

Confidentiality: An auditor should respect confidentiality of information acquired in the course of performing his work and should not disclose any such information unless there is specific authority from the client or there is a legal or professional reason for disclosure. It is equally important that he should ensure that the principle of confidentiality is observed by the members of staff under his control and others from whom he obtains advice and assistance.

Ethical behaviour: It is the duty of the auditor to refrain from any conduct that might bring discredit to the profession. The code of conduct laid down by the relevant professional body in this regard should be strictly observed. Such a code covers aspects such as responsibilities to the clients, to the members of the same professional body, to fellow auditors, to third parties and the general public.

Reliance on work performed by others: Where an auditor relies on work performed by other auditors (e.g., branch auditors appointed under the Companies Act) or experts or his own assistants, he should ensure that such persons have adequate skills and competence to carry out their work and should carefully direct, review and supervise their work. He should not forget the fact that when he delegates work to assistants, or makes use of work performed by others, he continues to be responsible for forming and expressing his own opinion on the financial statements.

Thorough documentation: It is important that an auditor should document matters that are important in providing sufficient evidence that the audit was carried out in accordance with the principles governing an audit. Such documentation should be aimed at recording and demonstrating the steps taken by the auditor to enable him to form an opinion on financial statements under his examination.

Proper planning: Proper planning of the audit work is a necessary prerequisite for effective and efficient conduct of an audit. Planning should be continuous throughout the engagement and plans should be revised to suit the developing circumstances. The auditor should study and evaluate the accounting system and the related internal controls instituted by the client's management in order to identify those controls on which audit reliance may be placed and then determine the nature, extent and timing of audit procedures to be carried out.

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Valid audit evidence: An auditor should obtain and retain relevant and valid audit evidence through the performance of compliance procedures and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on financial statements.

Adequate review of financial statements: An auditor should carry out a review of the financial statements in conjunction with the conclusions drawn from the audit evidence obtained during the course of the examination to form conclusions concerning the financial statements, with due consideration to the following points: (i) whether the financial statements have been prepared using acceptable accounting policies that have been consistently applied and are appropriate to the particular case; (ii) whether the financial statements comply with all relevant statutory requirements and other relevant regulations; (iii) whether the individual items appearing in the financial statements are consistent with each other, with known trends and with the auditor's knowledge of the business; (iv) whether the view presented by the financial statements as a whole is consistent with the auditor's knowledge of the business concerned; (v) whether there is sufficient disclosure of all material matters relevant to the proper presentation of financial statements and individual items contained therein are classified and presented in a proper manner; (vi) whether the conclusions drawn from the audit procedures carried out together with those drawn from the auditor's overall assessment of the financial statements enable him to draw enough conclusions for the expression of his opinion.

Clear preparation of audit report: The report through which the auditor is expressing his opinion on the financial statements subjected to his examination should be worded in an unambiguous manner. The absence of any comment in the report is equivalent to a positive statement by the auditor that he has investigated and satisfied himself on the points referred to in the preceding paragraph. Where an opinion other than unqualified is given, it should be direct and informative. It should be so phrased as to leave the reader in no doubt as to its meaning or the view formed by the auditor.

In conclusion, it may be stated that 'pride of service in preference to personal gain' is the sum total of the professional ethics of an auditor. A code of professional ethics of an auditor has the force of law as well as the result of discipline and conventions voluntarily established by members of the professional body. Any breach of the code would result in the person being disentitled to continue as a member of the professional body. This could rightly be considered as an assurance to the public that in case a member strays away from the path of duty, he would suitably be dealt with by the professional body. It may not be out of place to mention in this connection that the Council of the ICAI has been empowered to inquire into the conduct of any member of the Institute which may in the opinion of the Council be not desirable and/or expected of a chartered accountant and take appropriate disciplinary action.

Check Your Progress

1. What does the phrase 'reasonable care and skill' implies?
2. Mention the fine which arises with contravention of Sections 139 to 146 of the Companies Act 2013.
3. List the basic objectives which are the need of Code of Ethics.

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13.4 PROFESSIONAL MISCONDUCT OF STATUTORY AUDITOR

For the purposes of the Chartered Accountants Act, 1949, the expression "professional or other misconduct" shall be deemed to include any act or omission provided in any of the Schedules, but nothing in this Section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of Section 21 to inquire into the conduct of any member of the Institute under any other circumstances.

Schedule I of Chartered Accountants Act, 1949 is divided into four parts:

Part-I: Professional misconduct in relation to chartered accountants in practice

Part-II: Professional misconduct in relation to members of the Institute in service

Part-III: Professional misconduct in relation to members of the Institute generally and,

Part IV: Other misconduct in relation to members of the Institute generally

Schedule II of the Chartered Accountants Act, 1949 is divided into three parts:

Part-I: Professional misconduct in relation to chartered accountants in practice

Part-II: Professional misconduct in relation to members of the Institute generally

Part III: Other misconduct in relation to members of the Institute generally

The conditions, criteria and punishments related to professional misconduct are more serious and graver in the Schedule II in comparison to Schedule I. In this section, you will only learn about Part I of both the Schedules which relates to Professional misconduct in relation to chartered accountants in practice.

Schedule I

PART I: Professional misconduct in relation to chartered accountants in practice

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he –

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(1) allows any person to practice in his name as a chartered accountant unless such person is also a chartered accountant in practice and is in partnership with or employed by him;

(2) pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person other than a member of the Institute or a partner or a retired partner or the legal representative of a deceased partner, or a member of any other professional body or with such other persons having such qualifications as may be prescribed, for the purpose of rendering such professional services from time to time in or outside India. Explanation " In this item, "partner" includes a person residing outside India with whom a chartered accountant in practice has entered into partnership which is not in contravention of item (4) of this Part;

(3) accepts or agrees to accept any part of the profits of the professional work of a person who is not a member of the Institute: Provided that nothing herein contained shall be construed as prohibiting a member from entering into profit sharing or other similar 75 arrangements, including receiving any share commission or brokerage in the fees, with a member of such professional body or other person having qualifications, as is referred to in item (2) of this Part;

(4) enters into partnership, in or outside India, with any person other than a chartered accountant in practice or such other person who is a member of any other professional body having such qualifications as may be prescribed, including a resident who but for his residence abroad would be entitled to be registered as a member under clause (v) of sub-section (1) of Section 4 or whose qualifications are recognised by the Central Government or the Council for the purpose of permitting such partnerships;

(5) secures, either through the services of a person who is not an employee of such chartered accountant or who is not his partner or by means which are not open to a chartered accountant, any professional business: Provided that nothing herein contained shall be construed as prohibiting any arrangement permitted in terms of items (2), (3) and (4) of this Part;

(6) solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means: Provided that nothing herein contained shall be construed as preventing or prohibiting" 76 (i) any chartered accountant from applying or requesting for or inviting or securing professional work from another chartered accountant in practice; or (ii) a member from responding to tenders or enquiries issued by various users of professional services or organisations from time to time and securing professional work as a consequence;

(7) advertises his professional attainments or services, or uses any designation or expressions other than chartered accountant on professional documents,

visiting cards, letter heads or sign boards, unless it be a degree of a University established by law in India or recognised by the Central Government or a title indicating membership of the Institute of Chartered Accountants of India or of any other institution that has been recognised by the Central Government or may be recognised by the Council: Provided that a member in practice may advertise through a write up setting out the services provided by him or his firm and particulars of his firm subject to such guidelines2 as may be issued by the Council;

(8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing;

(9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of the Companies Act, 2013 in respect of such appointment have been duly complied with;

(10) charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are based on a percentage of profits or which are contingent upon the findings, or results of such employment, except as permitted under any regulation made under this Act;

(11) engages in any business or occupation other than the profession of chartered accountant unless permitted by the Council so to engage: Provided that nothing contained herein shall disentitle a chartered accountant from being a director of a company (not being a managing director or a whole time director) unless he or any of his partners is interested in such company as an auditor;

(12) allows a person not being a member of the Institute in practice, or a member not being his partner to sign on his behalf or on behalf of his firm, any balance-sheet, profit and loss account, report or financial statements.

Schedule II

PART I : Professional misconduct in relation to chartered accountants in practice

A chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he

(1) discloses information acquired in the course of his professional engagement to any person other than his client so engaging him, without the consent of his client or otherwise than as required by any law for the time being in force;

(2) certifies or submits in his name, or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice;

(3) permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that he vouches for the accuracy of the forecast;

(4) expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest;

(5) fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is 81 concerned with that financial statement in a professional capacity;

(6) fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity;

(7) does not exercise due diligence, or is grossly negligent in the conduct of his professional duties;

(8) fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion;

(9) fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances;

(10) fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.

13.5 PROCEDURE FOR ENQUIRY

As already mentioned in Unit7, the statutory auditor may be 'The auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf in the prescribed manner:

Provided that before taking any action under this sub-section, the auditor concerned shall be given a reasonable opportunity of being heard.'

You have already seen what constitutes professional misconduct in the previous section, Section 21 of the Chartered Accountants Act also lays down provisions related to the procedure for inquiry relating to misconduct of members of Institute:

1. Where on receipt of information by, or of a complaint made to it, the Council is prima facie of opinion that any member of the Institute has been guilty of any professional or other misconduct, the Council shall refer the case to the Disciplinary Committee, and the Disciplinary Committee shall thereupon hold such inquiry and in such manner as may be prescribed, and shall report the result of its inquiry to the Council.
2. If on receipt of such report the Council finds that the member of the Institute is not guilty of any professional or other misconduct, it shall record its finding accordingly and direct that the proceedings shall be filed or the complaint shall be dismissed, as the case may be.

3. If on receipt of such report the Council finds that the member of the Institute is guilty of any professional or other misconduct, it shall record a finding accordingly and shall proceed in the manner laid down in the succeeding sub-sections.
4. Where the finding is that a member of the Institute has been guilty of a professional misconduct specified in Schedule 1, the Council shall afford to the member an opportunity of being heard before orders are passed against him on the case, and may thereafter make any of the following orders, namely,-
    a) reprimand the member;
    b) remove the name of the member from the Register for such period, not exceeding five years, as the Council thinks fit:

    PROVIDED that where it appears to the Council that the case is one in which the name of the member ought to be removed from the Register for a period exceeding five years or permanently, it shall not make any order referred to in clause (a) or clause (b), but shall forward the case to the High Court with its recommendations thereon.
5. Where the misconduct in respect of which the Council has found any member of the Institute guilty is misconduct other than any such misconduct as is referred to in sub-section (4), it shall forward the case to the High Court with its recommendations thereon.
6. On receipt of any case under sub-section(4) or sub-section(5), the High Court shall fix a date for the hearing of the case and shall cause notice of the date so fixed, to be given to the member of the Institute concerned, the Council and to the Central Government, and shall afford such member, the Council and the Central Government an opportunity of being heard, and may thereafter make any of the following orders, namely
    a) direct that the proceedings be filed, or dismiss the complaint, as the case may be;
    b) reprimand the member;
    c) remove him from membership of the Institute either permanently or for such period as the High Court thinks fit;
    d) refer the case to the Council for further inquiry and report.
7. Where it appears to the High Court that the transfer of any case pending before it to another High Court, will promote the ends of justice or tend to the general convenience of the parties, it may so transfer the case, subject to such conditions, if any, as it thinks fit to impose, and the High Court to which such case is transferred shall deal with it as if the case had been forwarded to it by the Council. Explanation I: In this section "High Court" means the highest civil court of appeal, not including the Supreme Court, exercising jurisdiction in the area in which the person

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whose conduct is being inquired into carries on business, or has his principal place of business at the commencement of the inquiry: PROVIDED that where the cases relating to two or more members of the Institute have to be forwarded by the Council to different High Courts, the Central Government shall, having regard to the ends of the justice and the general convenience of the parties, determine which of the High Courts to the exclusion of others shall hear the cases against all the members. Explanation II: For the purposes of this section "member of the Institute" includes a person who was a member of the Institute on the date of the alleged misconduct although he has ceased to be a member of the Institute at the time of the inquiry.

8. For the purposes of any inquiry under this section, the Council and the Disciplinary Committee shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), in respect of the following matters, namely,-
   a) summoning and enforcing the attendance of any person and examining him on oath;
   b) he discovery and production of any document; and
   c) receiving evidence on affidavit.

Check Your Progress

4. When does the acceptance of appointment as an auditor considered professional misconduct as per Schedule 1 of the Chartered Accountants Act?
5. What are the orders that the Council can pass against the accountants in case of professional misconduct after being heard?

13.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The meaning of the phrase 'reasonable care and skill' depends on the particular circumstances of each case. Nevertheless, it implies that the accountant/auditor has to carry out his work in accordance with the generally accepted accounting/auditing standards issued by the professional bodies from time to time and that it should be in step with contemporary accounting/ auditing practices.
2. If any of the provisions of sections 139 to 146 (both inclusive) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with fine which

shall not be less than ten thousand rupees but which may extend to one lakh rupees.

3. The Four basic needs in the Code of Ethics involved in the objectives viz., credibility, professionalism, quality of service and confidence.
4. As per Schedule I of the Chartered Accountants Act, the appointment or acceptance of an auditor will be considered a professional misconduct if he:

   (8) accepts a position as auditor previously held by another chartered accountant or a certified auditor who has been issued certificate under the Restricted Certificate Rules, 1932 without first communicating with him in writing;

   (9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of the Companies Act, 2013 in respect of such appointment have been duly complied with;
5. As per Section 21 of the Chartered Accountants Act, Where the finding is that a member of the Institute has been guilty of a professional misconduct specified in Schedule 1, the Council shall afford to the member an opportunity of being heard before orders are passed against him on the case, and may thereafter make any of the following orders, namely,-

   c) reprimand the member;

   d) remove the name of the member from the Register for such period, not exceeding five years, as the Council thinks fit:

13.7 SUMMARY

- Liabilities of auditors in their professional capacity arise mainly from Liabilities under the Contract Act and Liabilities under the relevant statute, e.g., the Companies Act and/or the Penal Code, the Income Tax Act, the Chartered Accountants Act, etc.
- Liability for professional negligence arises irrespective of whether it is a private audit or a company statutory audit.
- Section 147 lays down the provisions related to the contravention of the provisions related to Audits and Auditors as mentioned in Chapter 10 of the Companies Act 2013.
- With a view to achieving objectives of credibility, professionalism, quality of service and confidence, chartered accountants in service have to display the following qualities: professional competence, knowledge of current developments, integrity and objectives, fairness, confidentiality, proper planning, valid audit evidence, etc.

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- Schedules I and II of the Chartered Accountants Act, 1949 specifies the provisions related to defining the professional misconduct in relation to Chartered Accountants.
- Section 21 of the Chartered Accountants Act also lays down provisions related to the procedure for inquiry relating to misconduct of members of Institute.

13.8 KEY WORDS

- **Liability:** In the context of an auditor, it refers to the legal responsibility of an auditor for something.
- **Code of ethics:** It refers to the guide of principles with respect to the conduct and behaviour of professionals engaged in a certain profession.
- **Professional misconduct:** As per the Chartered Accountants Act, it is 'deemed to include any act or omission provided in any of the Schedules, but nothing in this Section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under sub-section (1) of Section 21 to inquire into the conduct of any member of the Institute under any other circumstances.'

13.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Mention the sources from which the liabilities of auditors in their professional capacity arises.
2. Briefly mention the provisions related to the penalty for non-compliance by auditor as per the Companies Act 2013.
3. Write a short note on criminal liability of auditors.

Long Answer Questions

1. Discuss the professional ethics and qualities to be displayed by the chartered accountants.
2. Describe the main provisions related to the professional misconduct of statutory auditor under Chartered Accounts Act 1949.
3. Explain the provisions related to the procedure for inquiry relating to misconduct of members of Institute as mentioned in the Chartered Accountants Act.

13.10 FURTHER READINGS

Kumar, Ravinder and Virender Sharma. 2006. *Auditing: Principles and Practice*. New Delhi: PHI Learning Pvt. Ltd.

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UNIT 14 INVESTIGATION

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Structure

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14.0 INTRODUCTION

Up till now, you have learnt about the auditing needs and procedures in various types of undertakings. But it is important for you to note that besides conducting the important exercise of auditing, companies are also often required to carry out investigations into their account books and financial dealings for a variety of reasons. In this unit, you will learn about the objectives of investigation, along with the important provisions of the Companies Act 2013 with reference to investigation. You will also learn about the techniques of computer assisted audits and electronic auditing.

14.1 OBJECTIVES

After going through this unit, you will be able to:

- Explain the objectives of investigation
- Discuss the difference between computer based accounting and conventional accounting systems
- Describe the computer assisted auditing techniques and electronic auditing
- Examine the provisions of the Companies Act related to investigation

14.2 OBJECTIVES OF INVESTIGATION

'Investigation' in the context of accounting implies an examination of the accounts and records of a business with a definite object in view. Taylor and Perry define

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investigation thus: 'Investigation involves enquiry into facts behind the books of accounts into the technical, financial and economic position of the business or organization.' According to L R Howard, investigation is 'an examination of the accounts and balance sheet of an organization and the supporting documents for the specific purposes of obtaining information to be submitted to an interested party.'

Investigation is required to be carried out in companies for a variety of reasons. Some of these are:

- To judge the viability of acquiring a business or shares of a company
- To ascertain the credentials of an incoming partner
- To assess the financial health of an entity before granting loans
- To detect misappropriation of money and embezzlement
- To learn the truth about a suspected fraud

Such investigations into account books are normally carried out by qualified accountants who are well-versed in the techniques and modalities of account keeping. However, unlike for auditing, it is not mandatory that an investigation may be carried out only by a qualified accountant.

Investigator's Report

It is important for the investigating accountant to get clear instructions in writing as to the purpose for which his/her services are sought. This will avoid the possibilities of any misunderstandings or future disputes. Also, this will enable the accountant to decide on the extent of detailed work to be carried out and the manner in which his report has to be drafted. While drafting the report, the accountant should bear in mind the general reporting rules which may be summarized as under:

1. The main heading and subsequent sub-headings should be so worded as to make clear the subject of the report.
2. The exact period covered by the investigation should be stated.
3. The conclusions arrived at by the investigator should be given in the body of the report in a clear, concise and unambiguous manner.
4. References may be made to the detailed calculations and statistical data in the body of the report. But in order to make the report concise and to the point, these may be given separately by way of appendices to the report. All items of special importance and relevance to the client should be referred to specifically.
5. The report should not be so worded as to make it highly technical and sophisticated. The level of accounting knowledge and technical matters of the client should be kept in mind while drafting the report. In other words, the client should be able to understand clearly the exact position revealed by the report.

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6. Where the accountant has placed reliance on audited accounts, the exact extent of reliance on the work of the auditors should be mentioned.

In summary, it may be observed that all detailed workings and notes should be preserved by the accountant. It may be necessary for him to produce these later in the course of any litigation proceedings or otherwise.

14.3 AUDIT OF COMPUTERIZED ACCOUNTS AND ELECTRONIC AUDITING

At the very outset it was made clear that although the scope, objectives and general approach do not change by the introduction of a computerised system, the nature, timing and extent of carrying out audit procedures are likely to be affected by that system's characteristics. Hence it is necessary for the auditor to obtain a clear understanding of computer processing before commencing an audit of an enterprise using such a system.

14.3.1 Computer Based Accounting vs Conventional Accounting System

The principles, concepts and conventions followed in conventional and computer based accounting systems are same but the mechanism is where they differ. As the name implied, computer based accounting system makes the use of computer and internet to electronically record entries and maintain books of accounts.

Table 14.1 *Difference between Computer Based Accounting and Computerized Accounting*

Computer based Accounting	**Conventional Accounting**
It uses computer and accounting software to record entries electronically.	It uses physical registers as records.
Only data and formula entry are needed, calculations are done automatically	Here the calculations are done manually.
It makes use of customized database as book of records.	It uses book of original entry.
Here adjusting entries cannot be made.	Here the accountants can be rectification entries.
It can provide Trial Balance on a daily basis.	Trial balance is prepared when necessary.
The financial statement can be made with easy commands whenever needed.	The financial statements here are prepared only at the end of the accounting period.
It is a very fast method of accounting.	It is a comparatively slower method of accounting.
It helps the accountants by providing a back-up of data which can be saved whenever needed.	The process of backing-up is not available.

14.3.2 Appraisal of Accounting System and Related Internal Controls

Before undertaking detailed audit tests, there is a need for the auditor to investigate the client's system of internal control surrounding the accounting system. This will indicate to him the extent to which the records produced by the accounting system could be relied upon and will, in turn, enable him to decide on the extent of detailed checking necessary. As a result, the auditor will have to satisfy himself that the accounting system employed by the enterprise is correct. With a view to achieving this, the auditor has to review the accounting system and the related internal controls in operation. In a first time audit, or in a complex computer system, this review will be fairly comprehensive. Such a review is also necessary in the case of new applications and installations during the first year that the application/installation operates. In doing this, the auditor should also examine the controls on both the testing of the new applications (system testing) and the transfer to it of data and opening balances (data transfer) as elaborated in the previous section. Thereafter the review could be carried out every three to four years, unless a study of the situation during the intervening years indicates that changes which have been made in the system require a fresh review.

You have already learn about the basics of EDP and computerised accounting in Unit 11. Let's discuss the audit procedures in this section.

Review of General EDP Controls*

This review covers those activities which are common to the overall use of EDP by an enterprise. Very briefly, the activities covered are:

1. **Organisation and management controls**: Segregation of incompatible functions, such as:
   - data collection and coding;
   - data coding and processing;
   - programming and operations;
   - control and processing.

   From the auditor's point of view, where these controls are found to be weak, there is a fundamental risk to the integrity of all applications. It is true that weak controls in this area can be overcome by a high level of check and supervision. This may be particularly appropriate for smaller installations.
2. **(a) Computer operation controls**
   - proper authorisation of the use and access to computer;
   - detection of errors during processing.

   (b) Data entry and program controls
   - proper authorisation over transactions being entered into the system;
   - library control of data files and storage of source documents;
   - proper authorisation over access to data and programs.

   From the auditor's point of view, where these controls appear to be weak, he will find it difficult to place reliance on the system of internal control. He

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may check for any compensating controls over files and equipment, which could give sufficient protection to accounting data.

3. **Systems development and maintenance controls**
   - proper authorisation, approval, testing, implementation and documentation of changes to systems.

   Supervision and control over new applications, design and printing of standard documentation, will be of concern to the auditor who will be primarily interested in the system of authorising such developments and approving the respective phases of preparation prior to actual utilisation. The auditor's judgement of the system as a whole, will be mainly dependent on his assessment of the degree and adequacy of system testing and data transfer. Weaknesses in this area will influence the auditor's judgement on the extent of audit procedures to be carried out and will involve the auditor in much extra substantive testing.

4. **Software controls**
   - proper authorisation, approval, testing, implementation and documentation of changes in software;
   - library control of programs;
   - access to programs only by proper authorisation.

   From the auditor's point of view, weaknesses in these controls will mean his recognition of the fact that data can be manipulated. Of course, strong application controls could compensate these weaknesses although generally weaknesses in this area are regarded by the auditor as a serious control failure.

5. **Back-up and recovery controls**
   - offsite maintenance of data and programs (library control);
   - recovery procedures in case of theft, loss, deterioration or destruction of data and programs;
   - back-up for the equipment;
   - access authorisation.

Review of EDP Application Controls

Very briefly, this review covers the following:

1. **Documentation controls**
   - comprehensive system documentation;
   - updating documentation to reflect all system amendments;
   - remote maintenance of back-up copy of the documentation.

   From the auditor's point of view, these controls are important in that an up to date documentation enables him to understand the system properly.

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2. **Input controls**

- accurate and complete conversion of transactions into machine readable forms for processing;
- eliminating the possibility of improper or unauthorised changes in the transactions;
- rejection, correction and resubmission of incorrect transactions.

From the auditor's point of view, the importance of these controls stems from the fact that, the most important source of error or fraud in computerised systems, is incorrect or fraudulent input. Any significant weaknesses in this area will be a major source of concern for the auditor.

Personnel responsible for preparing the input will record the data. The computer will total the data as it is processed. The total as produced by the computer should be agreed with a prelist initially prepared. The auditor should ensure that this procedure is followed, and in a selected number of cases, he should compare the respective totals. Also, he should observe any additional controls which are part of the input procedures. These, for instance consist of "HASH TOTALS" (Hash totals consist of adding up all the code numbers being processed in a particular run. As such they have no special significance other than their control function. This total can be printed by the computer at intermediate or final processing stages. Hence it acts as a check that no data has been lost), DATA SCAN (Also known as DATA -VET - This is done by a data scan program by means of which the computer edits the input. It will automatically pick up code numbers which are invalid because of the presence of wrong number of digits, numbers outside specified parameters, or an incorrect balance between alpha and numeric digits), and RECORD COUNTS (also known as DOCUMENT COUNTS - The number invoices, vouchers, etc. being processed in a particular batch are counted before processing begins. This is usually done with the assistance of serial numbering. Once processing begins, the computer will verify the number of documents and the same total will be printed as part of the output. This is agreed with the predetermined total obtained before processing). Where the auditor considers it as significant, he should get details of all input printed in order to provide a visible record against which he can check the original documents.

3. **Processing controls**

- proper processing of transactions by ensuring that only relevant data is processed, that all data processed is accurate;
- identification and correction of processing errors;
- segregation of system analysts and programmers from the actual computer operations;

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- maintenance of a log book giving details of program runs and processing times, to prevent unauthorised processing.

From the auditor's point of view, these controls are important in that proper controls in this area will ensure that data is completely and accurately processed, and will enable the prevention or detection of errors or manipulation of data during all stages of processing. It is true that weaknesses in this area could be compensated by stringent controls over output.

Where the program includes a record count, the auditor should observe the effect of a discrepancy on the processing run, and make sure that the discrepancy is duly signified by the computer ceasing to function or proceeding to an error routine, depending upon programmed instructions. Built-in computer controls usually include "REASONABLE CHECKS". They set a limit for calculation of totals or input data. Any item in excess of the programmed limit should be the subject of an exception report. The auditor should test the function of this and other controls.

4. **Output controls**
   - ensuring the accuracy and completeness of the processing result;
   - restriction of access to output to only authorised personnel;
   - physical control of output.

   Where the auditor intends to place reliance on the system, this is an area within which key controls are absolutely necessary. If output is not properly controlled, all assurances provided by a well-controlled system for input and processing are likely to be neutralised.

   There is a need for the auditor to examine the printed output, which should include a record of the findings of all built-in controls. For instance, the total number of items processed in both quantity and value is usually printed out when processing is completed, and a comparison is made automatically with the input. Any discrepancy should be the subject of careful investigation. The auditor should also make sure that the user departments are properly carrying out any prescribed clerical controls on the information passed back to them by the computer department.

5. **Master file controls**
   - verification of the integrity of Master Files and standing data;
   - control and authorisation of all amendments to standing data;
   - control and restriction over access to application data files.

   From the auditor's point of view, this is also an area of utmost importance. Master Files and Standing Data Files are used in everyday processing. In addition, they are used in the preparation of final accounts. Where the Master/ Standing Data File in a system is wrong, then the accounts produced will also go wrong.

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Preliminary Evaluation

In carrying out a preliminary evaluation of the general EDP controls and EDP application controls, the auditor should strive to understand all relevant manual and EDP activities, especially the flow of transactions through the system. Application controls should not be evaluated in isolation. Weaknesses in general controls can affect adversely the effectiveness noticed in application controls, since general EDP controls have a pervasive effect on the risk that undetected fraud or error might occur during processing of transactions. It is true that under certain circumstances, weaknesses in general controls might be offset by very strong application controls. But it should be noted that weaknesses in application controls cannot be neutralised by the strength of general controls.

Where the preliminary evaluation of the controls indicates to the auditor that weaknesses in them preclude reliance on these controls, there is no need for him to continue with the review, or performance of compliance procedures. Instead, he may seek to continue the audit by gathering information from other sources.

Final Evaluation

Where the results of the preliminary evaluation are satisfactory, the auditor can proceed with compliance tests and thereafter substantive tests. It is through these compliance tests and final evaluation, that the auditor determines whether the controls on which he intends to place reliance were functioning properly throughout the period of intended reliance, and whether they can be relied on as planned in his preliminary evaluation. Where the evidence obtained indicates that the controls were not operating as designed, or the compliance tests indicate that the general EDP controls do not provide reasonable assurance that the EDP application controls functioned during the period of intended reliance, the final evaluation of the auditor may result in the discontinuance of the planned reliance. In such circumstances, he may seek to accomplish his audit objectives through the performance of other procedures. More specifically, the auditor should move directly to substantive tests, which may be assisted by the use of computer assisted audit techniques, about which a detailed discussion follows subsequently.

Factors Influencing Auditor's Decision Whether to Place Reliance on General Controls or Application Controls

As observed earlier, where the results of the preliminary evaluation are satisfactory, the auditor should design and carry out compliance procedures in case he wants to rely on the controls established by the enterprise. The following will be the important factors influencing the auditor in deciding whether to place reliance on the enterprise's general controls or application controls:

1. The most cost-effective method.
2. The auditor may decide to carry out compliance procedures in respect of application controls only in case these controls are entirely manual.

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Nevertheless, before placing reliance on application controls involving computer programs, it is necessary for the auditor to obtain reasonable assurance that the programs have operated properly. This is done by evaluating and testing the effect of relevant general controls, or by other tests on identified specific parts of the relevant programs.

3. It may so happen that a programmed accounting procedure is not subject to effective application controls. In that case, with a view to limiting the extent of substantive tests, the auditor may decide to carry out compliance tests either manually or with the help of computer assisted audit techniques, in order to obtain assurance of the continued and proper operation of the programmed accounting procedure. Where the results of the compliance tests are not satisfactory, the auditor will have to proceed directly to substantive tests.
4. As a result of program faults or hardware malfunction, system errors are likely in a computer environment. Most of these errors are prevented or detected by general controls. As such it may be necessary for the auditor to evaluate and test general controls.
5. Where mini computers are used, the auditor's reliance on general controls may remain limited, since most of these controls might not be properly evidenced, or because of the inconsistency in their operations. In such cases, if the auditor intends to limit his substantive tests, he may obtain assurance by carrying out compliance tests on manual application controls, or by testing specific parts of the programs.

While carrying out compliance tests, it is important for the auditor to obtain evidence which is relevant and appropriate to the control under examination. He can obtain such evidence through observation of the control in operation, sampling procedures, examination of documentary evidence of its operation, its performance by himself, etc. By testing identified specific parts of the program, or by reperforming them or by making use of computer assisted audit techniques, the auditor can obtain relevant evidence in the case of programmed application controls. In the case of relevant general controls, the auditor can obtain evidence by testing them.

Documentation of the Results of Evaluation

The results of the evaluation should be properly documented. In reviewing and documenting the controls, the auditor could make use of enquiry and review procedures similar to those as in manual systems described in an earlier chapter, and could make use of such techniques as flow charts, questionnaires, narrative descriptions, etc. Significant control weaknesses and any other restrictions which might influence the choice of audit approach should be clearly documented.

14.3.3 Computer Assisted Auditing Techniques and Electronic Auditing

An important tool, which the auditor can make use of in improving the effectiveness and efficiency of testing controls, as also of carrying out substantive tests in an

EDP environment, being computer assisted audit techniques (CAATs), what follows is a description of such techniques.

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In an EDP environment, sometimes manual procedures may be less efficient or less effective, because of the lack of visible evidence documenting the performance of the controls to be relied on (i.e., loss of audit trail and hence inability to trace individual transactions from source to completion that are possible in conventional audit tests), or because of the large volume of data to be tested. In such cases, computer assisted audit techniques will enable the auditor to obtain evidence. The most common types of CAATs are audit software and test packs.

(a) Audit Software Programs

These are computer programs used by the auditor, as part of his audit procedures, to interrogate, analyse and retrieve information held on computerised data files. They consist of package programs, purpose-written programs and utility programs. At the very outset, it may be mentioned that before making use of audit software, the auditor should substantiate their validity for audit purposes.

PACKAGE PROGRAMS are generalised computer programs designed to perform data processing functions which include reading computer files, selecting information, performing calculations, creating data files and printing reports in a format specified by the auditor.

PURPOSE-WRITTEN PROGRAMS are computer programs designed to perform audit tasks in specific circumstances. They may be developed by the auditor or by the enterprise, or by a third party engaged by the auditor. Programs used by the enterprise may also be suitable for audit purposes, either in their original form or with relevant modifications. This will be cost-effective as compared to developing altogether fresh programs.

UTILITY PROGRAMS are the programs used by the enterprise to perform common data processing functions such as sorting, creating files and printing files. Although, generally speaking, these programs are not designed for audit purposes, they will be found useful in performing audit procedures such as:

- tests of details of transactions and balances, as for example, to test all or a sample of the transactions in a computer file;
- analytical review procedures, as for example, to identify unusual fluctuations or items, etc.

The most commonly used audit software is 'INTERROGATION SOFTWARE'. This is used to perform calculations on the data print reports according to the requirements of the auditor; and total, summarise, compare or select data according to the specification of the auditor. Interrogation applications are useful to the auditor in a number of compliance testing procedures of computer controls such as:

(i) Verification of book-keeping and year-end account figures through the totalling of files.

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(ii) Selection of samples for statistical sampling, e.g. samples of data based on certain criteria such as items of high value.

(iii) Reperformance of computer calculations such as depreciation, interest charges, etc.

(iv) Highlighting items which require special attention e.g. payments exceeding authorised limits.

Control of Audit Software Applications

Audit software applications are controlled by the auditor through the following procedures:

(i) Participating in the design and testing of the computer programs.

(ii) Ensuring that the program conforms with the detailed program specifications by checking the coding of the program.

(iii) Ensuring that the concerned software can be used in the computer equipment of the enterprise, by requesting the computer personnel of the enterprise to review the operating system instructions.

(iv) Running the software on small test files prior to running on the main data files.

(v) Ensuring that the files used were the correct ones. For instance, by checking with external evidence, such as control totals maintained by the user.

(vi) Obtaining evidence that the audit software functioned as planned. For instance, by reviewing output and control information.

(vii) Ensuring that the data files of the enterprise are adequately safeguarded through appropriate security measures, thus eliminating the possibility of their manipulation.

(b) Test Packs (Test Data)

A test pack consists of devised input data (test data) which covers a complete range of transactions, including deliberate errors. The auditor then processes this through the computer. The results thus obtained are compared with predetermined results. This will assist the auditor in forming an opinion as to whether:

(a) input is being processed in accordance with the program; and

(b) the programmed exception routines are disclosing any invalid data presented. The following are examples of this technique:

(i) Test data used to test specific controls in computer programs such as on-line pass word and data access controls.

(ii) Test transactions taken from previously processed transactions or specially created by the auditor, with a view to testing processing characteristics of the relevant computer system.

(iii) Test data used to test access procedures to the program libraries.

(iv) Test data used to test the functioning of a programmed procedure.

(v) Test transactions used in an integrated test facility where a "dummy" unit is created, and to which test transactions are posted during the normal processing cycle.

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It may be mentioned in this connection that the tests as above are only valid within certain limits. They will only show that the computer is functioning correctly, under the program operating at the time the test pack is processed, and that the data has been processed correctly. Test packs do not provide details of the correct functioning of the computer at other times. Hence it is necessary that their use should be supplemented by use of computer programs, also devised by the auditor. In addition, the auditor may repeat the test on several occasions throughout the period of reliance. Of course test packs technique provides a more positive method of compliance testing program controls as compared to audit software.

Along with the use of interrogation software and test packs, the auditor should examine the procedures for dealing with exception or error reports, to ensure that invalid transactions are corrected and re-input for processing.

Control of Test Pack Applications

Test pack applications are controlled by the auditor through the following procedures:

(i) Where the test pack spans several processing cycles, the sequence of submission is controlled.

(ii) Test runs containing small quantity of test data are performed prior to the submission of main audit data.

(iii) The results of the test data are predicted and compared with the actual test data output, for the individual transactions and in total.

(iv) Ensuring that the test data was used by using the current version of the program.

(v) Ensuring that the programs used to process the test data were used by the enterprise throughout the applicable audit period.

Factors to be Considered in the use of CAATs

While deciding on the question whether to make use of computer assisted audit techniques in an EDP environment, the main factors to be considered by the auditor are:

(1) Computer knowledge, expertise and experience of the auditor - Depending on the complexity and nature of the particular CAAT technique adopted and of the accounting system of the enterprise, the auditor should possess the relevant knowledge, expertise and experience to plan, execute and use its results. In certain cases, the auditor may require significantly more computer knowledge and experience than others.

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(2) Availability of CAATs and suitable computer facilities - The availability of CAATs, appropriate computer facilities and appropriate computer based accounting systems have a bearing on the use of CAATs. In some cases, the auditor may have to use other computer facilities, e.g. where there is an incompatibility between the package program of the auditor and the computer of the enterprise. Even in cases where there is no incompatibility, the availability of computer time for audit purposes and the availability of suitable personnel of the enterprise will be necessary to facilitate processing by the auditor.

(3) Loss of audit trail - Improvements in computer processing speeds have resulted in "MANAGEMENT BY EXCEPTION" techniques, under which complete print out of the results of processing runs are not available. This often leads to a loss of audit trail whereby computer generated totals, analyses and balances lack supporting background data. Here, management is not exercising control through verification of the individual items processed. Usually, output is in the form of exception reports. These contain information requiring the attention of the management, and is generated by program instructions which require the computer to scan files, compare their contents with predetermined parameters set by the management, and to print out items/records which do not meet with such parameters. As far as the auditor is concerned, this results in a loss of audit trail, which makes it impracticable for the auditor to conduct conventional manual tests. Under these circumstances, he will have to make use of computer assisted audit techniques such as:

- Use of interrogation software whereby records held on magnetic files are printed out on a selective basis through direct request to those files.
- Use of test packs containing examples of both valid and invalid data compiled as a result of detailed reviews of client's programs. Computer solutions are compared with predetermined solutions, so that the correct functioning and reaction of programs are tested.
- Use of computer audit programs developed by the auditor. These are able to "interrogate" files and perform detailed tests and calculations upon files.

(4) Improvements in effectiveness and efficiency - By employing certain computer assisted audit techniques, it may be possible to improve the effectiveness and efficiency of audit procedures in obtaining and evaluating audit evidence. Examples include:

- Some transactions are examined more effectively for a similar cost, by using the computer to test all or a greater number of transactions.
- More efficient application of analytical review procedures by using the computer.

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- Additional substantive tests could be made more efficient by employing CAATs, as compared to reliance on controls and related compliance tests.
- In the case of CAATs with long life cycles, the initial planning, design and development of such techniques could be used in audits during subsequent periods, and hence they are cost-effective.

(5) Saving in time - Where the time available to complete the work of audit is limited, use of CAATs will be found better suited than other procedures.

Preparation for the Application of a CAAT

In the application of a computer assisted audit technique, the auditor should give consideration to the following steps:

(i) Determine the objective of the application.

(ii) Determine the content and accessibility of the files of the enterprise.

(iii) Determine the transaction types to be tested.

(iv) Determine the procedures to be performed on the data.

(v) Determine the output requirements.

(vi) Identify the audit and computer personnel who will be involved in the design and application of the CAAT.

(vii) Make sure that CAAT application is properly controlled and documented.

(viii) Make proper arrangements for the administrative activities such as necessary skills, computer facilities, etc.

(ix) Evaluate and refine the estimates of costs and benefits.

(x) Carry out CAAT application procedures.

(xi) Review and evaluate the results.

Documentation of CAAT Procedures

CAAT procedures should be properly documented and it should be consistent with that of the audit as a whole. The documentation should cover such aspects as planning, execution, audit evidence obtained and recommendations to management.

CAATs and Small Business EDP Environment

Although the general principles outlined above are valid in small business computer environments, the following points should be borne in mind while making use of CAATs in such environments:

(i) General EDP controls may not be extensive and effective in small business environments. As such the auditor may not be able to place reasonable assurance on the system of internal control. This, in turn, will mean that the auditor will have to give more emphasis on tests of details of transactions

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and balances, and analytical review procedures, which are likely to increase the effectiveness of certain CAATs, especially audit software. Also, the auditor will have to carry out audit procedures to make himself sure of the proper functioning of the CAAT and validity of the data of the enterprise.

(ii) Manual methods may be more cost effective where smaller volumes of data are processed.

(iii) The enterprise may not find it feasible to provide the auditor with the necessary technical assistance to carry out CAAT procedures. This makes the use of CAATs less practicable.

(iv) The computer environment of the enterprise may not be suitable for processing some of the test packs devised by the auditor, thus limiting the auditor's choice of the techniques. This limitation, however, can be overcome by taking copies of the data files of the enterprise and processing them on an alternative compatible computer.

Timing of Substantive Procedures

In conclusion, it may be observed that relevant data may not be maintained in computer files for a sufficient length of time, for use by the auditor to carry out the required audit procedures. As such, the auditor may find it necessary to make specific arrangements with the enterprise, either to retain printed output and to print out specific information for audit purposes throughout the year, or to carry out his audit procedures at more frequent intervals. Thus the timing of audit procedures will have to be adjusted according to the circumstances, and this contrasts with conventional systems, where information is generally available throughout the audit period.

14.4 INVESTIGATION UNDER THE PROVISIONS OF COMPANIES ACT

Let's have a look at what the Companies Act 2013 says about the situations, procedure and circumstances of investigation.

Investigation into Affairs of Company (Section 210)

(1) Where the Central Government is of the opinion, that it is necessary to investigate into the affairs of a company,—

  (a) on the receipt of a report of the Registrar or inspector under section 208;

  (b) on intimation of a special resolution passed by a company that the affairs of the company ought to be investigated; or

  (c) in public interest, it may order an investigation into the affairs of the company.

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(2) Where an order is passed by a court or the Tribunal in any proceedings before it that the affairs of a company ought to be investigated, the Central Government shall order an investigation into the affairs of that company.

(3) For the purposes of this section, the Central Government may appoint one or more persons as inspectors to investigate into the affairs of the company and to report thereon in such manner as the Central Government may direct.

Establishment of Serious Fraud Investigation Office (Section 211)

(1) The Central Government shall, by notification, establish an office to be called the Serious Fraud Investigation Office to investigate frauds relating to a company:

Provided that until the Serious Fraud Investigation Office is established under subsection (1), the Serious Fraud Investigation Office set-up by the Central Government in terms of the Government of India Resolution No. 45011/16/2003-Adm-I, dated the 2nd July, 2003 shall be deemed to be the Serious Fraud Investigation Office for the purpose of this section.

(2) The Serious Fraud Investigation Office shall be headed by a Director and consist of such number of experts from the following fields to be appointed by the Central Government from amongst persons of ability, integrity and experience in,—

(i) banking;

(ii) corporate affairs;

(iii) taxation;

(iv) forensic audit;

(v) capital market;

(vi) information technology;

(vii) law; or

(viii) such other fields as may be prescribed.

(3) The Central Government shall, by notification, appoint a Director in the Serious Fraud Investigation Office, who shall be an officer not below the rank of a Joint Secretary to the Government of India having knowledge and experience in dealing with matters relating to corporate affairs.

(4) The Central Government may appoint such experts and other officers and employees in the Serious Fraud Investigation Office as it considers necessary for the efficient discharge of its functions under this Act.

(5) The terms and conditions of service of Director, experts, and other officers and employees of the Serious Fraud Investigation Office shall be such as may be prescribed.

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Investigation into Company's Affairs in Other Cases (Section 213)

The Tribunal may,—

(a) on an application made by—

(i) not less than one hundred members or members holding not less than one-tenth of the total voting power, in the case of a company having a share capital; or

(ii) not less than one-fifth of the persons on the company's register of members, in the case of a company having no share capital, and supported by such evidence as may be necessary for the purpose of showing that the applicants have good reasons for seeking an order for conducting an investigation into the affairs of the company; or

(b) on an application made to it by any other person or otherwise, if it is satisfied that there are circumstances suggesting that—

(i) the business of the company is being conducted with intent to defraud its creditors, members or any other person or otherwise for a fraudulent or unlawful purpose, or in a manner oppressive to any of its members or that the company was formed for any fraudulent or unlawful purpose;

(ii) persons concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members; or

(iii) the members of the company have not been given all the information with respect to its affairs which they might reasonably expect, including information relating to the calculation of the commission payable to a managing or other director, or the manager, of the company, order, after giving a reasonable opportunity of being heard to the parties concerned, that the affairs of the company ought to be investigated by an inspector or inspectors appointed by the Central Government and where such an order is passed, the Central Government shall appoint one or more competent persons as inspectors to investigate into the affairs of the company in respect of such matters and to report thereupon to it in such manner as the Central Government may direct:

Provided that if after investigation it is proved that—

(i) the business of the company is being conducted with intent to defraud its creditors, members or any other persons or otherwise for a fraudulent or unlawful purpose, or that the company was formed for any fraudulent or unlawful purpose; or

(ii) any person concerned in the formation of the company or the management of its affairs have in connection therewith been guilty of fraud, then, every officer of the company who is in default and the person or persons concerned in the formation of the company or the management of its affairs shall be punishable for fraud in the manner as provided in section 447.

Security for Payment of Costs and Expenses of Investigation (section 214)

Where an investigation is ordered by the Central Government in pursuance of clause (b) of sub-section (1) of section 210, or in pursuance of an order made by the Tribunal under section 213, the Central Government may before appointing an inspector under subsection (3) of section 210 or clause (b) of section 213, require the applicant to give such security not exceeding twenty-five thousand rupees as may be prescribed, as it may think fit, for payment of the costs and expenses of the investigation and such security shall be refunded to the applicant if the investigation results in prosecution.

As per Section 215, no firm, body corporate or other association shall be appointed as an inspector.

Investigation of Ownership of Company (Section 216)

(1) Where it appears to the Central Government that there is a reason so to do, it may appoint one or more inspectors to investigate and report on matters relating to the company, and its membership for the purpose of determining the true persons—

  (*a*) who are or have been financially interested in the success or failure, whether real or apparent, of the company; or

  (*b*) who are or have been able to control or to materially influence the policy of the company; or

  (c) who have or had beneficial interest in shares of a company or who are or have been beneficial owners or significant beneficial owner of a company.

(2) Without prejudice to its powers under sub-section (*1*), the Central Government shall appoint one or more inspectors under that sub-section, if the Tribunal, in the course of any proceeding before it, directs by an order that the affairs of the company ought to be investigated as regards the membership of the company and other matters relating to the company, for the purposes specified in sub-section (*1*).

(3) While appointing an inspector under sub-section (*1*), the Central Government may define the scope of the investigation, whether as respects the matters or the period to which it is to extend or otherwise, and in particular, may limit the investigation to matters connected with particular shares or debentures.

(4) Subject to the terms of appointment of an inspector, his powers shall extend to the investigation of any circumstances suggesting the existence of any

arrangement or understanding which, though not legally binding, is or was observed or is likely to be observed in practice and which is relevant for the purposes of his investigation.

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Power of Inspector to Conduct Investigation into Affairs of Related Companies, etc. (Section 219)

If an inspector appointed under section 210 or section 212 or section 213 to investigate into the affairs of a company considers it necessary for the purposes of the investigation, to investigate also the affairs of—

(a) any other body corporate which is, or has at any relevant time been the company's subsidiary company or holding company, or a subsidiary company of its holding company;

(b) any other body corporate which is, or has at any relevant time been managed by any person as managing director or as manager, who is, or was, at the relevant time, the managing director or the manager of the company;

(c) any other body corporate whose Board of Directors comprises nominees of the company or is accustomed to act in accordance with the directions or instructions of the company or any of its directors; or

(d) any person who is or has at any relevant time been the company's managing director or manager or employee, he shall, subject to the prior approval of the Central Government, investigate into and report on the affairs of the other body corporate or of the managing director or manager, in so far as he considers that the results of his investigation are relevant to the investigation of the affairs of the company for which he is appointed.

Seizure of Documents by Inspector (Section 220)

(1) Where in the course of an investigation under this Chapter, the inspector has reasonable grounds to believe that the books and papers of, or relating to, any company or other body corporate or managing director or manager of such company are likely to be destroyed, mutilated, altered, falsified or secreted, the inspector may—

  (a) enter, with such assistance as may be required, the place or places where such books and papers are kept in such manner as may be required; and

  (b) seize books and papers as he considers necessary after allowing the company to take copies of, or extracts from, such books and papers at its cost for the purposes of his investigation.

(2) The inspector shall keep in his custody the books and papers seized under this section for such a period not later than the conclusion of the investigation as he considers necessary and thereafter shall return the same to the company or the other body corporate, or, as the case may be, to the managing director or the manager or any other person from whose custody or power they were seized:

Provided that the inspector may, before returning such books and papers as aforesaid, take copies of, or extracts from them or place identification marks on them or any part thereof or deal with the same in such manner as he considers necessary.

(3) The provisions of the Code of Criminal Procedure, 1973, relating to searches or seizures shall apply mutatis mutandis to every search or seizure made under this section.

Inspector's Report (Section 223)

(1) An inspector appointed under this Chapter may, and if so directed by the Central Government shall, submit interim reports to that Government, and on the conclusion of the investigation, shall submit a final report to the Central Government.

(2) Every report made under sub-section (1) shall be in writing or printed as the Central Government may direct.

(3) A copy of the report made under sub-section (1) may be obtained by members, creditors or any other person whose interest is likely to be affected by making an application in this regard to the Central Government.

(4) The report of any inspector appointed under this Chapter shall be authenticated either—

   (a) by the seal,if any, of the company whose affairs have been investigated; or

   (b) by a certificate of a public officer having the custody of the report, as provided under section 76 of the Indian Evidence Act, 1872, and such report shall be admissible in any legal proceeding as evidence in relation to any matter contained in the report.

(5) Nothing in this section shall apply to the report referred to in section 212.

Actions to be Taken in Pursuance of Inspector's Report (Section 224)

(1) If, from an inspector's report, made under section 223, it appears to the Central Government that any person has, in relation to the company or in relation to any other body corporate or other person whose affairs have been investigated under this Chapter been guilty of any offence for which he is criminally liable, the Central Government may prosecute such person for the offence and it shall be the duty of all officers and other employees of the company or body corporate to give the Central Government the necessary assistance in connection with the prosecution.

(2) If any company or other body corporate is liable to be wound up under this Act or under the Insolvency and Bankruptcy Code, 2016 and it appears to the Central Government from any such report made under section 223 that it is expedient so to do by reason of any such circumstances as are referred

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to in section 213, the Central Government may, unless the company or body corporate is already being wound up by the Tribunal, cause to be presented to the Tribunal by any person authorised by the Central Government in this behalf—

(a) a petition for the winding up of the company or body corporate on the ground that it is just and equitable that it should be wound up;

(b) an application under section 241; or

(c) both.

(3) If from any such report as aforesaid, it appears to the Central Government that proceedings ought, in the public interest, to be brought by the company or any body corporate whose affairs have been investigated under this Chapter—

(a) for the recovery of damages in respect of any fraud, misfeasance or other misconduct in connection with the promotion or formation, or the management of the affairs, of such company or body corporate; or

(b) for the recovery of any property of such company or body corporate which has been misapplied or wrongfully retained, the Central Government may itself bring proceedings for winding up in the name of such company or body corporate.

(4) The Central Government, shall be indemnified by such company or body corporate against any costs or expenses incurred by it in, or in connection with, any proceedings brought by virtue of sub-section (3).

(5) Where the report made by an inspector states that fraud has taken place in a company and due to such fraud any director, key managerial personnel, other officer of the company or any other person or entity, has taken undue advantage or benefit, whether in the form of any asset, property or cash or in any other manner, the Central Government may file an application before the Tribunal for appropriate orders with regard to disgorgement of such asset, property, or cash, as the case may be, and also for holding such director, key managerial personnel, officer or other person liable personally without any limitation of liability.

Check Your Progress

6. Who can establish the Serious Fraud Investigation Office?
7. What is fee required to be paid by an applicant to the Central Government before appointment of an inspector?
8. Who cannot be appointed as an inspector as per the Companies Act?

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14.5 ANSWERS TO 'CHECK YOUR PROGRESS'

1. Investigations into account books are normally carried out by qualified accountants who are well-versed in the techniques and modalities of account keeping. However, unlike for auditing, it is not mandatory that an investigation may be carried out only by a qualified accountant.
2. Before undertaking detailed audit tests, there is a need for the auditor to investigate the client's system of internal control surrounding the accounting system. This will indicate to him the extent to which the records produced by the accounting system could be relied upon, and will in turn, enable him to decide on the extent of detailed checking necessary.
3. Interrogation software are the most commonly used audit software which are used to perform calculations on the data print reports accounting to the requirements of the auditor; and total, summarise, compare or select data according to the specification of the auditor.
4. Test packs do not provide details of the correct functioning of the computer at other times. Hence it is necessary that their use should be supplemented by use of computer programs, also devised by the auditor.
5. CAAT procedures documentation should cover such aspects as planning, execution, audit evidence obtained and recommendations to management.
6. The Central Government shall, by notification, establish an office to be called the Serious Fraud Investigation Office to investigate frauds relating to a company:
7. Central Government may before appointing an inspector under subsection (3) of section 210 or clause (b) of section 213, require the applicant to give such security not exceeding twenty-five thousand rupees as may be prescribed, as it may think fit, for payment of the costs and expenses of the investigation and such security shall be refunded to the applicant if the investigation results in prosecution.
8. As per Section 215 of the Companies Act 2013**,** no firm, body corporate or other association shall be appointed as an inspector.

14.6 SUMMARY

- Investigation implies an examination of the accounts and records with a definite object in view.
- Investigation is required to be carried out in companies for a variety of reasons. Some of these are to judge the viability of acquiring a business or

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shares of a company, ascertain the credentials of an incoming partner, assess the financial health of an entity before granting loans, detect misappropriation of money and embezzlement or learn the truth about a suspected fraud.

- Before undertaking detailed audit tests, there is a need for the auditor to investigate the client's system of internal control surrounding the accounting system.
- The review of general EDP controls include activities like organisation and management controls, computer operation controls, data entry and program controls, system development and maintenance controls, software controls, back-up and recovery controls.
- Review of EDP application controls include documentation controls, input controls, processing controls, output controls and master file controls.
- In carrying out a preliminary evaluation of the general EDP controls and EDP application controls, the auditor should strive to understand all relevant manual and EDP activities, especially the flow of transactions through the system.
- Where the results of the preliminary evaluation are satisfactory, the auditor can proceed with compliance tests, and thereafter substantive tests. It is through these compliance tests and final evaluation, that the auditor determines whether the controls on which he intends to place reliance were functioning properly throughout.
- An important tool which the auditor can make use of in improving the effectiveness and efficiency of testing controls, as also of carrying out substantive tests in an EDP environment, being computer assisted audit techniques (CAATs).
- The most common types of CAATs are audit software and test packs.
- The factors to be considered by the auditor in the use of CAATs: computer knowledge and expertise, availability of CAATs and computer facilities, loss of audit trail, improvements in effectiveness and efficiency and saving of time.
- Chapter XIV (Sections 206-229) of the Companies Act on Inspection, Inquiry and Investigation and Sections 210-229 specifically deals with the provisions related to investigation.

14.7 KEY WORDS

- **Investigation**: In the context of accounting, it implies an examination of the accounts and records of a business with a definite object in view.

- **Audit Software Programs:** It refers to the computer programs used by the auditor, as part of his audit procedures, to interrogate, analyse and retrieve information held on computerised data files consisting of package programs, purpose-written programs and utility programs.
- **Test pack:** It consists of devised input data which covers a complete range of transactions, including deliberate errors.

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14.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. List the objectives for carrying out investigation in companies.
2. What are the general rules to be considering while drafting an investigator's report?
3. Differentiate between computerized accounting systems and conventional accounting systems.
4. Mention the factors influencing the auditor in deciding whether to place reliance on the enterprise's general controls or application controls.
5. What are the steps which should be considered while applying a computer assisted technique?
6. Write a short note on the actions to be taken in pursuance of inspector's report.

Long Answer Questions

1. Describe the activities covered in the review of general EDP controls.
2. Explain the review of general EDP controls.
3. Examine the review of EDP application controls.
4. Assess the audit software programmes and their control.
5. Discuss test packs and their control.
6. Analyse the factors to be considered in the use of CAATs.
7. Examine the provisions of the Companies Act on the investigation into the affairs of the company and company's affairs in other cases.
8. Discuss the provisions related to the powers of inspector to conduct investigation, seizure of documents and submission of inspector's report.

14.9 FURTHER READINGS

NOTES

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