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PAPER : IXB
AUDITING



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Paper IX -B

Auditing

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Suggested Questions

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Lesson 1

INTRODUCTION

Origin of Auditing

The origin of auditing may be traced back to the 18th century when the practice of large-scale production was developed as a result of Industrial Revolution. It is found that some systems of checks and counter checks were applied for maintaining accounts of public institutions, as early as the days of the ancient Egyptians, the Greek and the Romans.

The growth of Accounting profession in India is of a quite recent origin. It was an outcome of the Indian companies Act, 1913 which prescribed for the first time the qualifications of an auditor. Due to rapid growth in the size of business firms, it has become necessary that the accounts must be checked and audited by an independent person, known as auditor especially in case of joint-stock companies where the shareholders are drawn from far off places. That is why it becomes necessary to assure them that their investment is safe and that the directors and the managing directors etc. handling capital and accounts, have presented true and correct accounts.

Definition of Audit

The word "audit" is derived from the Latin word "audire" which means "to hear". In olden times, whenever the owners of, a business suspected fraud they appointed certain persons to check the accounts. Such persons sent for the accountants and "heard" whatever they had to say in connection with the accounts. Since then there have been lot of changes in the scope and definition of audit. The following are some of the definitions of audit given by some writers:

According to *spicer and Pegler,* "An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy himself that the balance sheet is properly drawn-up, so as to give a true and fair view of the state of the affairs of the business, and whether the profit and Loss Accounts gives a true and fair view of profit or loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books and if not, in what respect he is not satisfied"

R.B. Bose has defined as audit as "the verification of the accuracy and correctness of the books of account by independent person qualified for the job and not in any way connected with the preparation of such accounts." M.L. Shandily has defined auditing as "inspecting, comparing, checking, reviewing, vouching ascertaining scrutinising, examining and verifying the books of account of a business concern with a view to have a correct and true idea of its financial state of affairs".

From a closed scrutiny of the definitions given by various writers, it would be evident that these are different methods of saying a particular thing but still there is a lot of similarity therein. However, audit may be defined as :

1. an intelligent and a critical examination of the books of account of a business which,
2. is done by an independent person or body of persons qualified for the job,
3. With the help of vouchers, documents, information and explanations received from the authorities, so that,
4. the auditor may satisfy himself with the authenticity of financial accounts prepared for a fixed term and ultimately report that,
   (i) the Balance Sheet exhibits a true and fair view of the state of affairs of the concern,

(ii) the Profit and Loss Account reveals the true and fair view of the profit or loss for the financial period, and

(iii) the accounts have been prepared in conformity with the law. In short, an audit implies an investigation and a report.

Difference between Accountancy and Auditing

The difference between Accountancy and Auditing is as follows :

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

Book-Keeping, Accountancy and Auditing

Book-Keeping, Accountancy and Auditing are the three aspects of the term 'Accountancy' itself in its widest sense.

Book-keeping is the art of recording the daily transactions in a set of financial books. It is concerned with systematic recording of transaction in the books of original entry and their posting into ledger. A person with the knowledge of rules of journalizing and posting can very easily do the job. In some countries like Africa & England, this work is done by machines.

Accountancy

Accountancy begins where book-keeping ends." It means that an accountant comes into the picture only when the book keeper has done his job. The functions of accountant can be classified as under :

(i) Checking the work of book-keeper.

(ii) Preparation of trial balance,

(iii) Preparation of Trading and Profit and loss Account.

(iv) Preparation of balance sheet,

(v) Passing entries for rectification of errors and making adjustments.

An accountant is supposed to be an expert in the accounting procedures as he has to examine analytically the final accounts. But it is not necessary for him to pass the chartered Accountant's examination. He it's not supposed to submit his report after the completion of work.

Auditing

It is said, "where accountancy ends, auditing begins." It is sightly said. An auditor has to verify the entries passed by the accountant and the final accounts prepared by him. Thus, auditing is the checking of the accounts of a business with the help of vouchers, documents and the information given to him and the explainations submitted to him. An auditor has to satisfy himself after due verification and

complete. Checking of accounts as to whether the transactions entered into the books are accurate. An auditer is required to submit his report to the effect whether or not the balance sheet is a true and fair representation of the existing state of affairs of a business concern.

Thus, an auditor should have the proper knowledge of accounting principles. That is why he should be a chartered Accountant. He has to express his impartial opinion in his report which he can not give unless he satisfies himself completely with the proper recording of transactions. Thus, auditing is based on accountancy and not accountancy on auditing. An auditor must be well familiar with the principles and practical aspects of accountancy but it is not necessary for an accountant to be an expert in the audit work.

The following table makes the distinction clear among book-keeping accountancy and Auditing.

(a)	Book-keeping (Recording & Balancing) (the Practical Part)	1. Journalizing. 2. Posting into Ledger. 3. Totalling of different accounts in the Ledger, and 4. Balancing, 5. Checking the work of the Book-keeper. 6. Preparation of Trial Balance,
(b)	Accountancy (summary and Analysis) (Theoretical part)	7. Preparation of Trading & Profit & laws account, 8. Preparation of Balance sheet, 9. Passing entries for rectification of errors and making adjustments,
(c)	Auditing (Examination of Records) (the Analytical part)	10. Checking the work done by the accountant.

Audit and Investigations

There is a lot of difference between auditing and investigation which is as follows :

1. Audit is conducted to find out whether the balance sheet is properly drawn up and exhibits a true and fair view of the state of affairs of the business while investigation means a searching enquiry with certain object in view, e.g.; to find out the profit earning capacity, or the financial position of a concern or a fraud and the extent thereof.
2. Investigation covers several years, say, 3,5, and 7 years to find out the average earning capacity, financial position, etc. of a concern while audit usually relates to one year.
3. Investigation may be carried out on behalf of outsiders who either want to purchase the business, to become partners, to advance loans or to purchase the shares of a firm. Audit is always conducted on behalf of proprietors only. However investigation may also be carried out on behalf of proprietors in case fraud is suspected.
4. Audited accounts are further investigated for some special purpose in view while investigated accounts are not audited in the ordinary course.
5. Audit is legally compulsory, specially in case of companies, but investigation is voluntary and depends upon the necessity of some purpose in view.

Objects of an Audit

The main object of audit is to verify the accounts and to report whether the Balance Sheet and the Profit and Loss Account have been drawn up properly according to the companies Act and whether they exhibits

a true and fair view of the state of affairs of the concern. For this, an auditor has to discover errors and frauds. As such the subsidiary objects of audit are :

(i) Detection and Prevention of errors,

(ii) Detection and Prevention of frauds.

The difference between an error and fraud is that error generally arises out of the innocence or carelessness on the part of those responsible for the preparation of accounts, while fraud involves some intention to gain out of manipulating records.

Types of Errors

A. *Clerical Errors :* Clerical errors are those which result on account of wrong posting that is posting an item to a wrong account, totalling and balancing. Such errors may again be subdivided into:

(i) *Errors of Omission :* An error of omission takes place when a transaction is completely or partially not recorded in books of account. For example, goods purchased from Narendra Kumar were not recorded any where in account books. This error will not affect the agreement of Trial Balance. But if posting is not done in one of the accounts, this will affect the agreement of Trial Balance.

(ii) *Errors of Commission :* Errors of commission take place when some transaction in incorrectly recorded in books of account. Following are the examples of such errors :

(i) Error in the books of Original Entry.

(ii) Debiting or crediting one account instead of the other.

These two errors do not affect the agreement of Trial Balance,

(iii) Wrong balancing of an account.

(iv) Error in writing amount in an account. For example, debiting Prem Chand' s Account with Rs. 107- instead of Rs. 100/-.

(v) Casting of the same amount to two accounts.

(vi) Posting of an amount on the wrong side.

(vii) Posting in one account and omitting of posting in the other account.

(viii) Error in carrying forward the total of a subsidiary book or an account from one page to the other.

These errors affect the agreement of Trial Balance.

B. *Errors of principle :* Errors of Principle take place when a transaction is recorded without having regard to the fundamental principles of book-keeping and accountancy. For example a capital expenditure, say expenses incurred in constructing a godown, may be treated as a revenue expenditure or vice versa, Sometimes adjustments are not taken into consideration while preparing Final Accounts. These are errors of principle. These errors, however, do not affect the agreement of the Trial Balance.

C. *Compensating Errors* :- Compensating errors arise when an error is counter balanced or compensated by any other error so that the adverse effect of one on debit (or credit) side is neutralised by that of another on credit (or debit) side. For example Rani's account was to be debited with Rs. 10, but it was debited with Rs. 100 similarly Shyam's account was debited with Rs. 10 instead of Rs. 100. Both these errors compensate each other's deficiency and will not affect the agreement of the Trial Balance.

Detection of Errors :- Although it is not the duty of the auditor to trace and locate errors in the books which he is required to check and audit as this is the work of an accountant but in many cases the auditor is frequently asked to discover the errors, specially so, when the accountant is unable to locate such errors. While locating errors, the auditor should take note of following devices :-

1. Check the totals of the trial balance.
2. Compare the names of the accounts in the ledger with the names of the accounts as have been recorded in the trial balance.
3. Total the list of debtors and creditors and compare them with the trial balance.
4. I f the books are maintained on the self-balancing system, see that the total of different accounts agrees with the total of these accounts with the balance of accounts as recorded in the[1] trial balance.
5. Compare the items of the trial balance with the items of the trial balance of the previous year to see if any item have been omitted.
6. Whatever the difference is in the trial balance, see if there is any item of this amount. This is done to avoid the putting of the debit balance on the credit side of the trial balance

   or vice versa.
7. It is possible that the totals of some subsidiary books, e.g. Cash book, Sales book etc. might not have been transferred to the trial balance. Recheck the totals of these books.

Detection and Prevention of Fraud

Fraud means false representation or entry made intentionally or without being in its truth with a view to defraud somebody. Detection of fraud is considered to be one of the important duties of an auditor.

Fraud may be of three types

1. *Misappropriation of Cash* : It is easier to misappropriate cash, therefore the auditor will have to pay particular attention towards cash transaction. Cash may be misappropriated by,

(a) Omitting to enter any cash which has been received; or

(b) Entering less account than what has been actually received; or

(c) making fictitious entries on the payment side of the cash book; or

(d) entering more amount on the payment side of the Cash Book than what has been actually paid.

In order to discover fraud under (a) and (b) above, the auditor should check the debit side of the cash book with rough cash book, salesmen's reports, counterfoils of the receipt books, agent's returns and other original records while the fraud under (c) and (d) can be discovered by reference to the vouchers, wage sheets, salary book invoices, etc.

2. *Misappropriation of Goods* :- This type of fraud is very difficult to detect especially when the goods are less bulky and are of higher value. Proper methods of keeping accounts in regard to purchases and sales, stock, taking, periodical checking of stocks, comparing the percentage of gross profit to sales of two periods, necessity for collusion will help to avoid misappropriation of goods.

3. *Fraudulent Manipulation of Accounts :* This type of fraud is more difficult to discover as it is usually committed by directors or managers or other responsible officials. That is why the auditor

should be very careful in detecting such frauds. He should carry out the routine checking and vouching most carefully and make searching, tactful and intelligent enquiries. Such a fraud is committed with the following two objects :-

(a) Showing more profits than what actually they are so as to increase the commission payable on the basis of profits, borrow money by showing a better position, to attract more subscribers for the sale of the shares of the company etc. or

(b) Showing less profits than what actually they are so as to purchase shares in the market at a lower price ; or to reduce or avoid the payment of income tax or to mislead a prospective buyer of the business etc.

The accounts may be manipulated in a number of ways which are as follows:

1. by not providing any depreciation or less depreciation or more depreciation; or
2. by under valuation or over-valuation of assets and liabilities; or
3. by showing fictitious sales or purchases or returns in order to show more profits or less profits whatever the case may be ; or
4. by showing revenue expenditure to capital account or vice versa.
5. by the utilization of secret reserves during a period when the concern has made less or no profit without disclosing that fact to the shareholders etc.

Auditor's duty with regard to detection and prevention of frauds and errors.

The legal perception of auditor's duty with regard to detection and prevention of frauds and errors has undergone various charges. Initially, it was based on the decision given in kingston cotton mills co. [1896] case. The learned. Judge Lopse summed up auditor's duty by stating, "Auditor is a watchdog, not a blood hound. This statement implies.

1. In case of a limited company, an auditor is appointed by the shareholders. Thus, he is expected to play the role of a watch do on their behalf and should look after their interests.

2. Unlike a blood bound the duty of the auditor is verification and not detection. If he finds out something suspicious during the course of audit, he should enquire the matter in detail and inform the shareholders about it. But if he does not discover any such suspicious matter, he is fully justified in trusting and relying an representations made by the employees of the company. In briefly, in case of errors and frauds, the auditor has a duty of reasonable care only.

In recent years, auditor's duty has been extended in some cases, besides shareholders, to third parties. But the condition is that his negligence is proved. This is in recognition of public pressure on auditors to take more responsibility for detection of fraud in pursuance of their role of lending credibility to financial statements. The judgement in 'Headly Byrne and Co. Ltd. V. Heller and partners Ltd. Co. (1963) recognised for the first time the liability of professionals including company auditors towards third parties.

Advantages of Auditing

It is of great importance to get accounts audited in a proprietary concern to see that business is running efficiently, in a partnership firm to ensure healthy relations among partners and especially to decide questions like valuation of goodwill at the time of entry, retirement and death of a partner and in joint stock company in which shareholders invest their money and presume their capital intact if accounts of such a company are audited by some qualified auditor. Audit is made compulsory also under the companies Act.

The advantages of audit can be grouped into the following categories :

A. for Business itself :

1. The accounts of a business and its financial position can be examined by an independent and qualified auditor.
2. Quick discovery of errors and frauds—Errors and frauds are located very easily and at early stage. Therefore, chances of their repetition are reduced to the minimum.
3. Moral check on the Employees—Through auditing, the staff maintaining accounts become more alert and careful in keeping future accounts up-to-date.
4. Loans and credit can easily be obtained from banks and other money lenders on the basis of properly audited accounts.
5. The business itself enjoys better reputation due to audited accounts.
6. In case of Advice to the management—regular audit, the auditor can come into close touch with the working of the business & thus, can give suggestions the management to improve it in case he is asked to do so.
7. Audit is useful in case of a business managed by some agent or representative of its owner.
8. Uniformity in accounts if the accounts have been prepared on a uniform basis, accounts of one year can be compared with other years and if there is any discrepancy, the cause may be enquired into.

B. For the owners of Business

1. If the business is owned by a sale trader, he can rely well on the audited and on his accounts clerks who are responsible for maintaining accounts.
2. In case of partnership firm, its partners can utilize the audited accounts to settle their disputes in regard to adjustment of capital and valuation of goodwill at the time of admission, retirement and death of a partner.
3. In case of a joint stock company. Shareholders living at distant places can rely on audited accounts and can be sure of their investment being sage with the company.
4. In case of a trust, its trustees can easily make their position clear before others by getting the accounts audited by an dutside auditor.

C. For others

1. Filling of Income Tax Return—Income Tax authorities generally accept the profit & loss account that has been prepared by a qualified auditor and they do not go into details of accounts.
2. Settlement of Insurance claim—In case of fire, flood and the like unexpected happenings, the insurare company may settle the claim for loss or damages on the basis of audited accounts of the previous year.
3. Sales Tax payments—The audited books of accounts may generally be accepted by the sales tax authorities.
4. Payment of wealth-tax, expenditure-tax etc.—The taxation authorities can also rely on audited accounts for the purpose of imposing wealth tax, expenditure-tax etc.

5. Actions against Bankruptcy and insolvency—The audited accounts of a business can be produced in support of a legal case before the court. It forms a basis to determine action in bankruptcy and insolvency cases.
6. Future trends of the business—The future trends of the business can be assessed with certainty from the audited books of accounts.

Limitations of Auditing

Truly speaking an audit should have no limitation of its own. It is designed to protect the interest of all parties who are interested in the affairs of the business. If these is any short coming arising there from, it may be due to its narrow scope of application in its related field of operations and un-extended designition of the concept. The audit has following limitations.

1. Lack of complete picture—The audit may not give complete picture. If the accounts are prepared with the intention to defraud others, auditor may not be able to detect them.
2. Problem of Dependence—Sometimes the auditor has to depend on explanations, clarification and information from staff and the client. He may or may not get correct or complete information.
3. Existence of error in the audited accounts—Due to time and cost constraints, the auditor can not examine all the transactions. He uses sampling to check the transactions. As a result, there may be errors & frauds in the audited accounts even after the checking by the auditor.
4. Exercise of judgement—The nature, timing and extent of audit procedures to be performed is a matter of professional judgement of the auditor. The same audit work can be done by two different auditors with difference in sincerity & personal judgement.
5. Diversified situations—Auditing is considered to be a mechanical work. Auditors may not be in a position to frame audit programme which can be followed in all situations.
6. Lack of Expertise—In some situations, an auditor has to take opinion of experts on certain matters on which he may not have expert's knowledge. The auditor has to depend upon such reports which may not be always correct.
7. Limitations of internal control—The auditor can only report on the truth and fairness of the financial statements. But other problems relating the management and control may not be possible to be covered by the auditor. Examples of such problems or limitations of internal control are cast-ineffectiveness, manipulations by management, etc.
8. Influence of management on the auditor—This is also come of the limitations of the audit that the auditor is influenced by the doings of those in management. The reason is that he is appointed by the share holders and directors who pay him remuneration or fee.

Classification of Audit

Audit may be classified into two categories mainly ; - (a) according to organizational structure of a business; and (b) from practical point of view.

According to Organizational Structure of a Business

1. Statutory Audit

In case of many undertakings, audit is made compulsory under statute because these undertakings are established by statute. The audit of their accounts is termed as statutory audit. The following are the examples of such an audit:

(i) *Company Audit:-* The audit of joint stock companies compulsory under the companies act. For the first time the Indian Companies Act, 1913, made it legally compulsory for joint-stock companies in India to get their accounts audited by an independent professional accountant, but now, the companies Act, 1956 and subsequent amendments have made tremendous changes in the rights, duties, powers etc., of an auditor.

(ii) *Audit of Trusts* :- Trust are usually created for the benefit of the weak and helpless persons like widows, minors etc., who are not in a position to have access to and understand the accounts of such trusts. Therefore the trustees are made responsible to look after the property and to maintain accounts. But in a large number of cases, the trustees either do not maintain accounts at all or if they are forced to do so, such accounts are very often misleading. To avoid such a situation specific provisions are sometimes made in the trust deed for the appointment of auditors to check the accounts of the trusts. In some of the state in India, Public Trust Acts, (for example, the Bombay Public Trust Act, 1950 etc.) have been enacted which provide for compulsory audit of the accounts of trust by qualified auditors.

(iii) *Audit of other institutions :-* There are other corporate bodies such as electricity and gas companies which has been formed under their respective statutes. There is another set of public bodies in the name of public corporations, for example, Reserve Bank of India, Industrial Financial Corporation, etc.; Which work according to the various Acts passed for the purpose. All these institutions fully recognise the significance of a professional audit which is compulsory for them. The powers, duties and liabilities of auditors are also well defined and fixed by statues.

2. Private Audit

The institutions which are private in character also get their accounts audited by some qualified auditors. As such an audit is not required by statute, it is known as private audit. There may be three types of such institutions which are as follows :

(i) *Audit of the accounts of Sole Trader* :- The appointment of an auditor in case of a proprietary concern rests absolutely on the proprietor. His rights, duties and nature of work will depend upon the terms given in the agreement. Such an auditor must get clear instruction in writing by his client as to what he has to do and how he has to proceed so that he can be held responsible for any charge of negligence and by producing the agreement, he can protect himself against such a charge.

(ii) *Audit of the Accounts of partnership Firms :-* In case of a partnership firm, the auditor is appointed by agreement between the partners. His rights, duties and liabilities are also defined by mutual agreement and can be subjected to modification.

(iii) *Audit of the accounts of other individuals and institutions :-* There are other individuals, e.g., rent collectors, estate managers, etc., who have large income and huge expenditure. The qualified auditors are appointed by these individuals in order to verify various accounts prepared by the accountants.

3. Government Audit

The Government maintains a separate department in the name of accounts and audit department which performs the audit of its different departments and offices. This department is headed by the Comptroller and Auditor General of India who is assisted by different officials at various levels.

The duties and liabilities of such auditors are not defined by statue. They are not public auditors and hence can not be appointed auditors for public concerns. They are meant for Government departments and as such, they work according to departmental rules and instructions.

4. Internal Audit

By virtue of the organizational pattern, some business institutions appoint auditors who are made responsible to have a constant and regular review of their accounts. Such auditors are of a permanent nature and are known as internal auditors. Such auditors, besides checking the accounts are required to report also as to how the system of accounting can be improved and the system of internal check be made economical and efficient. They can not be appointed as public auditors or external auditors and hence are not required to submit their reports in the manner in which external auditors do.

In short internal audit is the examination of books of account which is conducted by the salaried officials of a business known as internal auditors throughout the year. The scope of internal audit is a bit different. It is more closely related to managerial functions than to accounting duties.

From Practical Point of View :

All those forms in which audit is often conducted practically by business houses are as follows :-

1. Continuous Audit or Detailed Audit.
2. Periodical audit or Final Audit or complete Audit.
3. Interim Audit.
4. Occasional Audit.
5. Partial Audit.
6. Balance Sheet Audit.
7. Cash Audit.
8. Cost Audit.

1. **Continuous Audit or Detailed Audit :-** According to spicer and pegler "A continuous Audit is one where the auditors staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year, and performs an interim audit; such audits are adopted where the work involved is considerable, have many points in their favour, although they are subject to certain disadvantages."

Thus, a continuous audit involves the conducting of audit of accounts throughout the year at regular intervals, fixed or otherwise, of say, one month or months. The accounts in such a case are subjected to audit as and when they are prepared. Such an audit is necessary only for big business houses.

Continuous Audit is applicable in case of following business concerns:

(i) where final accounts are prepared just after the close of the financial year, as in the case of a bank.

(ii) where the transactions are many in number and thus it becomes necessary to get them audited at regular intervals.

(iii) where the system of internal check in operation is not satisfactory.

(iv) where the statements of accounts are prepared after every month or quarter to be presented to the management.

(v) where sales effected are very large.

Advantage of Continuous Audit :

1. Easy and quick discovery of Errors and frauds: Errors and frauds can be discovered easily and quickly as the auditor checks the accounts at regular intervals and in details.

2. Helps the auditor in making valuable suggestions: since the auditor remains more in touch with the business, he is in a position to know the technical details of it and hence can be of great help to his clients by making valuable suggestions.
3. Quick presentations of accounts: As the checking work is already performed during the year, the final audited accounts can be presented to the share-holders soon after the close of the financial year at the annual general meeting.
4. Keeps the client's staff regular: As the auditor visits the clients at regular intervals, the clerk will be very regular in keeping the accounts up-to-date.
5. Moral cheek on the clients staff: If the auditor pays surprise visits, it will have a considerable moral check on the clerks preparing the accounts.
6. Efficient Audit: As the auditor has more time at his disposal, he can check the accounts with greater attention and in detail and his work will be more efficient.
7. Preparation of Interim Accounts : If the directors of a company wish to declare an interim dividend. Continuous audit will help in the preparation of the interim accounts without much delay,
8. Audit staff can be kept busy: The audit staff may be sent to other clients after having finished the work for one client and thus can be kept busy throughout the year.

Disadvantages :

1. Alteration of figures: Figures in the books of account which have already been checked by the auditor at his previous visit, may be altered by a dishonest clerk to defraud the accounts.
2. Dislocation of client's work: As the auditor visits frequently, it may dislocate the work of his client and cause inconvenience to the latter.
3. Expensive: It is an expensive system of audit as such an audit is carried on throughout the financial year at regular intervals.
4. Queries may remain outstanding : As there may be a long interval between the two visits, the audit clerk may lose the link between the past and present work and the queries which he wanted to-make may remain outstanding.
5. Mechanical work: Under such an audit, the work of the auditors becomes mechanical and his frequent visits may also cause boredom to him.

Precautions to guard against its disadvantages :

1. The auditor should issue clear instructions to the effect that the audited figures should not be changed without bringing itto his notice. If some alteration is necessary it should be done by passing rectification entries in the journal.
2. He should try to check the accounts of similar nature in one and continuous sitting as far as possible and if not possible he should check the transaction up to a particular date. He should also note important totals and balances up to that date in his diary and compare them at his next visit,
3. The auditor should prepare an exhaustive programme to prevent any loop-holes.
4. The explanations of important questions which he finds unsatisfactory should be noted in his note-book and efforts should be made to get the matters settled.
5. He should go through the past work and alterations, if any, before he begins his work.

6. The checking of impersonal accounts should be undertaken at the time of final audit because the fraud in personal accounts can easily be made by passing false entries in the impersonal accounts,
7. Special ticks should be used by the auditor while checking altered figures,
8. He should pay surprise visits so that the clerks of the client may not know the exact date of the visit of the auditor.

2. Periodical of Final or Complete Audit:- That system under which the auditor takes up his work of checking the books of account and other related documents, only at the end of the accounting period when the transactions for the whole period are completely recorded, balanced and a Trading profit and Loss Account and the Balance Sheet have been prepared, is known as periodical or final audit, He would complete his audit work in one continuous session or without any interval, In other words the auditor visits his client only once a year and goes on checking the accounts and other related documents until the audit work for the whole of the period is completed.

Advantages :

1. The Work of audit does not present any inconvenience and dislocation in the work of the concern as the auditor comes only once a year.
2. It is less expensive and more useful for small business concerns than continuous audit.
3. In periodical audit the work of the auditor can be finished quickly and within a reasonable time.
4. The audit work does not become mechanical for the auditor.
5. Undue collusion is not established between the auditor and the clerks.

Disadvantages :

1. In periodical audit, detailed checking of accounts is not possible.
2. There is a greater chance of errors and frauds in accounts as the auditor visits his client only once a year and not at regular intervals.
3. If such a audit is undertaken in large concerns it takes more time to complete the audit and hence presentation of auditor's report to the shareholders is delayed. But shareholders are usually very anxious for the dividends which cannot be declared until the final accounts have been prepared and audited. Therefore, such an audit is not practicable for big concerns.

Difference between continuous Audit and final Audit

1. Under continuous audit, the auditor or his staff, for the purpose of checking the accounts, visits his client's at regular or irregular interval during the financial year. On the other hand, in case of final audit, he visits the cilent only at the end of the accounting period.
2. In continuous audit, the audit work is carried on almost simultaneously with the recording of transactions, while in final audit, accounts are audited much after their recording.
3. Continuous audit is commenced and carried on before the close of the financial period to which it is related. While final audit is undertaken when all the accounts have been recorded, balanced and a Trading and Profit and Loss Account and the Balance Sheet have been prepared.

3. Interim Audit :- Interim audit is one which is conducted in between the two annual audits for some interim purpose, say, to enable a company to declare an interim dividend. This kind of audit involves a complete checking of the accounts prepared by a company for a part of the year to the date set of interim accounts, say, quarterly or half-yearly accounts.

Advantages :

1. This audit is helpful when the publication of interim figures becomes necessary.
2. With interim audit, the final audit can be completed easily and within short period of time.
3. Errors and frauds can be more quickly found and detected during the course of the year.
4. Since the interim audit is performed during the course of a year, it helps in exercising moral check on the staff of the cilent.

Disadvantages :

1. There is greater possibility of altering figures in the accounts which have already been audited.
2. Interim audit involves additional work as the audit staff will have to prepare notes after finishing the interim audit.

Distinction between Continuous Audit and Interim Audit :

1. In case of continuous audit, the auditor undertakes the audit work for the whole financial year at intervals according to cilent's own need and convenience, while in interim audit, the audit, work is done only up to a definite date.
2. Under continuous audit, verification of Assets and Liabilities is done at the close of the financial year, but under interim audit, this work is done at the time of audit.
3. When continuous audit is done, the trial balance is not to be prepared necessarily at intervals, but in case of interim audit, the trial balance has to be prepared.
4. The auditor has to give the report at the close of financial year when continuous audit is done, but in case of interim audit, such a report is to be submitted at the time of audit.

4. Occassional Audit:- An audit which is conducted occasionally, that is, once a while whenever the need arises and the client desires it to be undertaken. For instance, the audit is not compulsory in case of sole proprietorship and partnership business but whenever the need arises, the owners can get the accounts audited.

5. Partial audit:- Under partial audit, an auditor is asked to check some of the records and books for a part or whole of the period. For example, auditor may be instructed to audit only the payment side of the cash book because he himself receives cash and cheques on behalf of his business. Such an audit is not permitted in case of private or public limited companies.

6. Balance Sheet Audit :- Under such an audit, the auditor checks capital, reserves, assets, liabilities, etc., given in the Balance Sheet. Those items of Trading and Profits and Loss Account are also checked which have a bearing on the Balance Sheet items. For example, the purchase of goods on credit will increase the liabilities to creditors, increase the stock and will be shown in the Trading Account as an increase in purchases and closing stock. So this item will have to be verified. This type of audit can be successful in those business concerns where efficient system of internal check and control is in operation. Such an audit is popular in U.S.A.

Lesson 2

Internal Check, Internal Audit And Internal Control

Internal Check

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

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

The essential elements of an internal check are :

(a) Instituting of checks on day-to-day transactions.

(b) These checks operate continuously as a part of routine system.

(c) Work of each person is made complementary to the work of another.

The objective of such allocation of the duties is that no one has an exclusive control over any transaction.

Internal check system in the various aspects of the accounting is given below :

Internal check as regards cash

There should be a proper system of internal ^heck in respect of all transactions because majority of the frauds arise in connection with cash. The auditor must familiarise himself with the system of internal check in operation. Duties in respect of cash should be divided in such a manner that there is automatic check on the various functionaries connected with cash section. It is necessary that employees of the cash are encouraged to go on vacation. Rotation of duties relating to cash section should also be enforced.

Internal check as regards Cash Receipts

1. The cashier should not have access to the incoming mail books (which do not concern him), petty cash funds and the ledgers.
2. Remittances should be opened by the cashier in the presence of a responsible person. All cheques and bank drafts received should be marked - 'Not negotiable A/c Payee only.'
3. All the receipts of the day should be deposited in the bank at the end of the day or the next morning.
4. On receiving cash, it should be acknowledged by issuing a printed receipt. This receipt should have a counterfoil. These receipts should be consecutively numbered. The receipt should be kept under lock and key.

5. Cash registers should be used.

6. The cashier should prepare the paying-in-slips to be retained by the bank. However, the counter-foils of the paying-in-slips should be entered by some other clerk and not by the Cashier.

7. Cash sales should be so organised as to reduce the chances of misappropriation to the minimum.

8. As far as possible the system of collection by travellers should be discouraged. However, if they are authorised to collect debts on behalf of the business, there should be proper rules and regulations.

9. Bank reconciliation statement should be made by cashier and someone else frequently.

Internal check as regards cash payments

1. As far as possible, all payments should be made by cheques authorised by a responsible person and signed by responsible persons. Cheques should be marked' A/c Payee only' before they are despatched. Unused cheque books should be kept under lock and key by a responsible person.

2. Employees authorised to sign or countersign cheques should not have any other duty connected with cash. Otherwise, it will provide them with opportunity to influence entries in the ledgers.

3. Petty cash should be maintained under the imprest system.

4. There should be an efficient system of internal check as regards wages (discussed elsewhere in this chapter).

5. Vouchers should be numbered properly and filed in order. The cashier should not be asked to do this.

6. There should be a proper internal check system of cash sales (discussed in this chapter).

7. Castings of cash book should be independently checked.

Internal check as regards wages

In case of manufacturing concerns wage bill is of great magnitude. The system of internal check is of great importance in such concerns as regards wages. Any system of internal check as regards wages much counteract the following dangers -

(i) Inadequate time records. This may result in the workers receiving wages for time not devoted.

(ii) Inadequate piece work records. This will result in workers receiving wages for work not done.

(iii) Errors in preparation of wage-sheets or pay rolls,

(iv) Manipulation of wage sheet by inserting dummies.

The system of internal check to be suggested will vary according to each particular case. However, to counter-act the above dangers, the following system of internal check is suggested :

1. *Time Records :* Where the wages are to be paid according to the time basis, the times of employees entering and leaving the work should be recorded. This may be done either by a gatekeeper or time recording clock. Further, the foreman of each department should take the time of entering and leaving the department. This will not only act as a counter-check on the original records but also as a deterrent to wasting to times by the workers.

2. *Piece work records :* Where wages are paid on piece-wages basis, an efficient system of recording piece work is essential. When the work is given, it should be entered in the concerned piece worker's card. On completion, this card should be signed by the worker and foreman. Where necessary, it should be signed by the store-keeper.

3. *Preparation of wage-sheets :* Separate wage-sheets should be used for time workers and piece workers. They should be ruled to record all the essential particulars. Special columns should be provided for the gross amount payable, deductions for employees, state insurance, provident fund contribution, loans, fines etc. and the net amount payable. Columns should also be provided showing the employers' contribution under the Employees State Insurance Act.

For time workers, the gate-keepers records and departmental time records should be compared by two clerks in the wage office. Discrepancy, if any, should be enquired into. A third clerks should record on the wages sheet, the name of the employees, rate of wages and other particulars. These entries should be checked by another clerk. Net amount payable to each worker should be calculated by another clerk. Similarly, wage sheets should be prepared for the piece workers following the above procedure. It should be remembered that each wage clerk should initial for that portion of work connected with wage sheet undertaken by him. All the wage sheets should be counter signed by the Works Manager, a Director or a Partner.

4. *Payment of wages :* Wages should be paid by Cashier. The cashier should not have any hand in the preparation of wage sheets. A separate cheque should be drawn for the precise amount of the wages. The workers should attend personally to receive their wages in the presence of their foreman to avoid impersonation. Wages of the absentees should be paid to a worker only when he has brought letter of authority. The Works Manager or some responsible officer should be present at the time of payment.

Internal check as regards purchases

For this purpose the system of internal check to be adopted by any concern will depend on its size and resources. However, the following system of internal check for purchases is suggested -

1. All the orders for purchases should be recorded in the Purchases Order Book. They should be properly authorised. A carbon-copy of every order placed should be kept.
2. On receipt of the goods, the gate-keeper or store-keeper should make a record in the Goods Inwards Books.
3. Invoices received from the sellers should be checked with the Orders Books and Goods Inwards Books as to its quality, quantity, prices and calculations. The clerks checking them should also initial the invoices. After this invoices should be entered in the Bought Day Book and filed.
4. In case, there are a number of departments, each placing its order, the invoice should be sent to the concerned department for checking.
5. Entry for all goods purchased should be made by an independent person in the stores ledger.
6. The payment of every invoice should be authorised by a responsible official.
7. A proper system of internal check for cash purchases should be in operation. As far as possible, cash purchases should be discouraged.

Internal check as regards sales

Chances of errors and frauds are greater in the case of sales. Goods sent on approval being treated as actual sales or entering of fictitious sales in the sales book is possible. Further, it is possible that the next year's sales may be taken as this year's or sale of fixed assets recorded as sale of goods.

The object of internal check should be to counteract the above.

1. All orders received should be recorded properly and in writing. Orders received on telephone or verbally should be confirmed in writing.
2. All goods supplied should be recorded in the Goods Outward Book.
3. Invoice should be prepared in duplicate - one copy sent to the customer and other carbon copy should be kept. Details of every invoice should be checked before sent out. Entries in Goods Outwards Book should be compared with invoices.
4. Entries should be made in the sales Book on the basis of invoices.
5. Goods returned by the customer should be entered in the returns inwards book and a credit note be prepared.
6. In case of cash sales, cash should be received by a person other than salesman. Goods should be delivered on the basis of the receipt cash memo.

Internal Check and Auditor

How far an auditor can rely on the internal check system ? This is not an easy question to answer. The answer to this question will depend upon the size and nature of the business. Before he can decide upon the reliance on internal check system, he will have to take the following steps :-

1. Seek a statement from his client in this regard.
2. Examine the system taking into account the size and nature of the business.
3. Examine the system especially from its weakest point to assess the possibilities of errors and frauds.

If the auditor finds that the system of internal check is defective, he should carry on detailed checking.

An efficient system of internal check can reduce to a great extent the work of the auditor but does not reduce his liability. On the other hand, a defective system makes his work difficult.

INTERNAL AUDIT

Internal audit is the review of operations and records undertaken within a business by specially assigned staff on a continuous basis. Internal audit has been defined as "the independent appraisal of activity within an organization for the review of accounting, financial and other business practices as a protective and constructive arm of management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of controls." Therefore it is clear that internal audit not only includes the verifications of accounting matters but also financial and other matters.

Objects of Internal Audit

1. To verify the correctness of the financial accounting and statistical records presented to the management.
2. To comment on the effectiveness of the internal control system and the internal check system in force and to suggest means to improve them.
3. To facilitate the early detection and prevention of frauds.
4. To ensure that the standard accounting practices to be followed by the organization are strictly followed.
5. To confirm that the liabilities have been incurred by the organization in respect of its legitimate activities.
6. To examine the protection provided to assets and the uses to which they are put.

7. To undertake special investigation for the management.
8. To identify the authorities responsible for purchasing assets and other item as well as disposal of assets.

Distinction Between Internal Check and Internal Audit

1. Internal check is an arrangement of as duties allocated in such a way that the work of one clerk is automatically checked by another while internal audit is an independent review of operations and records undertaken by the staff specially appointed for the purpose.
2. In Internal audit, a separate salaried staff of internal auditors is entrusted with the audit work but in internal check, there is no separate staff appointed especially for this purpose. Different clerks are assigned with various tasks with which they proceed and carry on checking at the same time.
3. In Internal audit, the work of a clerk is checked by an internal auditor after the former has finished the work while in case of internal check, the work of one clerk is automatically and independently checked by another simultaneously.
4. In internal audit, errors and frauds which have already been committed can be discovered but the system of internal check is so devised that the possibilities of errors and frauds are reduced to the minimum.

Internal control

Internal control has been defined as being "no 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 the company in on orderly,manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records."

Therefore internal control is a broad term with a wide coverage. Its scope extends beyond those matters which relate directly to the functions of accounting and financial records. In its modern sense, audit control includes two types of controls:

(a) *Accounting Controls :* These comprise primarily the plan of organization and the procedures and records that are concerned with and directly related to the safeguarding of assets and reliability of financial records. These include budgeting control, standard costing, control accounts, bank reconciliation, self balancing ledgers and internal auditing etc.

(b) *Administrative Controls :* These comprise the plan of organization that are concerned mainly with operational efficiency. They may include controls, such as time and motion studies, quality controls through inspection, performance reports and statistical analysis.

From the point of view of the auditor, the distinction between these two controls, is very significant. An auditor has to make a careful review of the accounting controls in order ensure the accuracy and adequacy of financial statements. He is not expected to review the administration controls because they have only a remote relationship with financial records. However he may evaluate only those administrative controls that have a bearing on the reliability of financial statements.

Characteristics of Good Internal Control System

1. There should be a well developed plan of organization with delegation of proper responsibilities at various levels of operational hierarchy.
2. These should be a scientifically developed system of record procedures with a view to maintain reasonable control over assets, liabilities, revenues and expenses.

3. A system of healthy practices and traditions is also necessary for the performance of duties and activities of various departments of the organization.
4. The personnel engaged in the business should be of high quality and character with a deep understanding of their responsibilities and a proper background of training and ability. This is necessary because controls are exercised by personnel engaged in the business.
5. There should be managerial supervision and reviews of the company's financial operation and positions at regular and frequent intervals by means of interim accounts and reports and operating summaries etc.

Divisions of Internal control

Depending upon the nature of business and the environment in which it works, the main divisions of an overall internal control system are:

1. *General Financial Control :* This control includes a proper efficient system of accounting, adequate supervision, recording and duplicating systems, good efficient staff and the maintenance of healthy relationships amongst the staff.
2. *Cash Control*: The system includes certain important aspects of control for receipts, payments and balances held. A proper system of internal check must operate at all stages. There may be specially deputed officials including the internal audit staff to exercise checks at regular and irregular intervals. Effort should be made to avoid misappropriation of cash.
3. *Employee Remuneration :* The system must cover all sections of employee remuneration and maintenance of records for remuneration, their preparation and methods of payment should be brought under tight control. So pacific instructions must be issued to the staff concerned.
4. *Trading Transactions :* These refer to the purchases, sales etc. So in respect of these transactions, effective procedure should laid down for acquisitions, handling and accounting of goods purchased or sold.
5. *Fixed Assets :* Capital expenditure on fixed assets should be kept under strict check and supervision. The authority right from sanctioning of capital expenditure to its use should be clearly defined so that any type of misappropriation by officials of the organization can be reduced to the minimum.
6. *Stock maintenance :* Stocks of raw materials, work-in-progress and finished goods should be properly maintained and accounted for. Regular stock taking procedures are quite helpful as means of independent, checks and reconciliation of records.
7. *Investments :* The procedures of control in regard to investments cover such measures as authorisation, recording and maintaining record of investments held and safeguarding the documents of title.

Internal control and the Auditor

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

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

(ii) Whether an effective internal auditing department exist or not.

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

(iv) How extensive examination he should carry out in different areas of accounting.

(v) How far administrative control has a bearing on his work.

(vi) What should be the appropriate audit programme in existing circumstances.

(vii) To what extent reliability can be placed on the reports, records and the certificates of the management.

(viii) Whether some suggestion can be given to improve the existing control system.

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

AUDIT PROCESS

Audit Programme

Before starting an audit, a programme of the work to be done on the audit, known as audit programme, is generally drawn by the Chief Auditor. He outlines a programme according to the requirement of each case as to what work is to be done by senior and junior staff and the time by which the work is to be finished. While preparing the audit programme of each audit, the auditor should keep in mind the nature of internal control and its extent as well as the size and composition of the business.

According to Professor Meigs, "An Audit Programme is a detailed plan of the auditing work to be performed, specifying the procedures to be followed in verification of each item in the financial statements and giving the estimated time required."

Therefore an audit programme provides a guide in arranging and distributing the work and in checking against the possibility of omissions.

A Specimen of Audit Programme is given as below :—

Messers.....and Co., Ltd.

Year Months	Cash Book Balanced	Bank Balance Checked	Purchase Book Balanced	Sales Book Balanced	Trial Balance Checked	Profit & Loss A/c Checked
January						
February						
_____						
_____						

Here it should be noted that each audit assistant has to put in his initial in the relevant column after he has checked a particular item so that the responsibility may rest upon him for the work he has done.

Advantages

1. It provides assistants with a set of clear instructions about their duties.
2. It enables the auditor to keep constantly in touch with the work done and the general progress of the audit.
3. It serves as an evidence in case of a charge of negligence against the auditor in the performance of his duties.
4. The chance of work being over-looked is considerably reduced. In case an audit assistant goes on leave, the portion of work done by him can easily be located and the unfinished work can be resumed by another without any difficulty.
5. In case any fraud or error has remained undetected, the responsibly for negligence can be fixed on the clerk performing that work as his initials are put on the audit programme.

6. A uniformity of work can be obtained, as the same programme will be followed at subsequent audits.
7. It serves as a guide to the duty for a new clerk.
8. It facilitates the final review before the report is signed.
9. It provides for systematic audits routine and therefore eliminates inefficiency.
10. It is useful basis for planning the programme for the subsequent years.

Limitations

1. The work may became too mechanical and the clerks do not get enough opportunities to show their intelligence and initiative as they have to follow a predetermined programme.
2. It is not proper to frame a rigid programme for cash type of business because each business may have different problems and procedures.
3. An audit programme, which may be detailed and well drawn up may no cover everything that might come up during the course of audit.
4. The programme may be subjected to amendment due to changes in work or procedures. Actually the audit programme for each new audit should be an improvement over previous one.
5. It would be unnecessary to prepare a programme for small business concerns.
6. Inefficient and careless auditors or audit clerks may try to conceal their weaknesses on the basis of audit programme.

These limitations can be minimised by treating audit programme as a guidance only and making it flexible so that audit clerks may use their initiative and intelligence during the audit, make suggestions for improving it from time to time keeping in view the experience and changes in the business.

Working Papers

Working papers are those papers which consist of details about accounts which are under audit so that the auditor may not have again to go over the accounts of his client if he wants to refer to them later on during the course of audit. Working papers consist of working trial balances, adjusting entries, account analysis, schedules of debtors and creditors, particulars of investment and of depreciation, copies of correspondencee between auditors and debtors, creditors, and banks etc. -previous audit reports, important quaries with explanations completed audit programme etc.

Objects of working Papers :

1. To show the extent to which accounting principles and auditing standards have been followed.
2. To support the audit report.
3. To serve as an evidence in case of any suit against the auditors for negligence in the performance of his duties.
4. To enable the auditor to know the weaknesses of the internal control system and give advise to his client to avoid such weaknesses.
5. To serve as a means to provide training to the audit clerks about the ways of summarising the work done by them.
6. To help the auditor to plan for the subsequent years.
7. To enable the auditor to prepare the report to be issued without any dealy.
8. To assign the unfinished work of one clerk to another without dislocation, duplication and omission of any work in case changes and transfer of staff are very frequent.

Characteristics of good working papers

1. They should be complete in all respects. In other words, they should contain all the essential information so that they may be of maximum utility.
2. Working papers should be properly organised and arranged so that one may not find any difficulty in locating a particular matter.
3. Paper used for working papers should be of good quality and of convenient and uniform size so that it may not be damaged by frequent handling.

Protection and ownership or Working Papers

The working papers are highly confidential papers and therefore, must be kept in safe custody. They are not to be shown to any party which might make misuse of them. With regard to the ownership of these papers, there is a controversy as to whether these papers belong to the client or to the auditor. The client claims that since the auditor is his agent, he has no line on these papers. On the other hand, the auditor claims these papers to be his property on the basis that he has collected the information for the purpose of discharging his duties. Actually these papers come to the help of the auditor in future in case the client files a suit against the auditor for negligence etc. it is also argues that the outgoing auditor should hand over these papers to incoming auditor but he should not do so if there is some kind of suspicion or doubt in his mind. In many cases, it was held that these papers belonged to the auditor and not to the client.

Evidence in Auditing

Auditing is concerned with the verification and examination of accounting data. In this process an auditor collects and evaluates evidence to establish facts and to draw conclusions and inferences. It is an accepted standard of auditing that "sufficient competent evidential matter is to be obtained through inspection observation, inquiries and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination". There an auditor should understand the nature and type of evidence available in various auditing situations. Further he should" be able to evaluate the sufficiency which refers to adequacy of such evidence and the competency which refers to the quality or reliability of evidence.

The concept of evidence is fundamental to auditing. All audit techniques and procedures are derived from it. It helps the auditor in pereiving the types of evidence available in an audit situation, collecting it through the various audit techniques and evaluating its sufficiency and competency to support accounting data.

According to Mautz and Sharaf development of this concept contains the following steps :-

1. Recognition of the propositions to be proved.
2. Evaluation of the propositions in terms of significance.
3. Collection of evidence within the given limits of time and cost.
4. Evaluation of the evidence obtained as valid or not valid.
5. Formation of judgement as to the propositions at issue.

Recognition of the Propositions to be Proved

First of all, the auditor is to perceive and recognise what he is trying to prove. In other words, he must be clear about the propositions in support of which evidence is required. The accounting statements, which an auditor reviews, consist of a series of propositions. For example one of the propositions in balance sheet is that the enterprise has fixed assets, debtors cash etc.

Evaluation of Propositions

After the propositions behind accounting data being identified they must be evaluated according to their significance or materiality. In other words, various propositions may be classified into those which are

very significant, those which are moderately material, and those which are not so material. Materality is a relative concept and depends upon the size and nature of an item. It is natural that an auditor must collect quantitatively more compelling evidence in case of significant propositions, than in case of propositions which are not so material. Therefore, there is a direct link between the materiality of a proposition and the quality of evidence required to support it.

Collection of Evidence

By applying various audit techniques an auditor collects different types of evidence to support the propositions made in the accounting data. The audit programme lists the manner in which such evidence is to be collected within the constraints of time and cost.

There can be many types of evidence. The auditor must recognise the various classes of evidence and their nature. Some are given as below :

(i) *Physical examination of the existence of the things represented in accounts* : Direct examination, inspection, or counting is a strong evidence of the existence of tangible assets. But such an evidence has some limitations. Firstly, it is not available for all types of propositions. Secondly, it does not prove the ownership of the asset as mere existence does not indicate the ownership.

(ii) *Statements by independent third parties :* An auditor can have strong evidence if an independent party makes a written or oral statement in support of certain facts, provided that the party is competent to make such a statement. For example, sundry debtors, creditors, bills receivable, bill payable balances with banks etc. can be verified by obtaining written statements from competent parties.

(iii) *Authoritative Documents :* These constitute the main source of evidence available to an auditor. These documents include purchase invoices, cancelled cheques, copies of sale invoices and cash memos, counterfoils of receipts, vouchers, official minutes, contracts, insurance policies and all other documents which are created as various transactions happen.

(iv) *Statements by officers and employees of the company under audit :* During the course of audit, an auditor often requires the officers and other employees to provide him with detailed explanation and information. Such statements may be formal or informal. But such an evidence is less reliable.

(v) *Calculations performed by the auditors :* The propositions regarding mathematical accuracy can be supported best by recalculation of such amounts by the auditor. Thus an auditor may verify totals of ledger accounts in order to verify their arithmetical accuracy.

(vi) *Satisfactory internal control system :* By evaluating the internal control system, an auditor can find out the degree of reliance that can be placed on various systems, and procedures. So auditor gets satisfied about the reliability of the records and accounting data.

(vii) *Subsequent actions by the company under audit:* As the actual audit is under taken only after the close of the accounting year, an auditor can find evidence for a number of propositions in certain actions and events happening after the balance sheet date. For example a good evidence for cheques shown as deposited but not cleared at the close of the accounting year would be the fact whether such cheques have subsequently been cleared.

(viii) *Subsidiary or detailed records:* subsidiary or detailed records like stores ledger, finished stock ledger etc. maintained properly and regularly provide a supporting evidence to the auditor that the main data supported by such records are reliable.

(ix) *Inter-relationships with other data :* Accounting data can be interrelated with data and thus used as a strong evidence. For example an auditor can work out the input output ratios in quantitative terms as supporting evidence for the figures of production, sales, and raw materials consumed.

Evaluation of Audit Evidence

After the evidence being collected the auditor must evaluate it critically with regard to its usefulness. Auditor, like historians and mathematicians must develop professional standards to such an extent that they can be used to evaluate audit evidence.

Formation of judgement: The last steps is to form an opinion about the various propositions by the auditor after he has identified the propositions behind the accounting data, evaluated them according to their significance, collected evidence through the audit techniques, critically reviewed the evidence as regards, it validity. In forming his judgemnt the auditor is not looking for absolute proof. He has to find evidence which assures that the accounting data under report fairly represent the reality as far as it can be determined.

Audit Sampling (Selective Verification)

The main objective of audit is to formulate an overall opinion on the accounts and the financial statements. The accounts of the large size enterprises have a large number of transactions. So it may be physically impossible for auditor to check each and every transaction. For example, The total number of payments made by a large bank and its branches in a year may be so large that an auditor cannot verify all of them. If he attempts to do so, it would probably take him many years to complete the audit and that too at great cost. Therefore an auditor has to undertake selective verification.

Selective verification is a significant auditing procedure. Under this, the auditor selects some transactions out of the large mass of repetitive data in a manner that he can draw valid conclusion after a thorough examination of the selected transactions. Selective verification enables him to complete his audit within reasonable time and cost. As, in most cases, detailed checking serves no purpose at all, it becomes mechanical and the auditor gets so much tied down with the larger number of individual transactions that he loses the overall view of accounts. By selecting some representative transactions and examining them in depth, an auditor can form a better opinion on the financial statements than by mechanically ticking off all the entries. Selective verification enables the auditor to concentrate on the essentials. Almost all professional bodies recognise that an auditor may resort to selective verification.

No doubt a risk is involved in selecting and checking only some transactions and this is the risk of overlooking errors. But this is present even when all entries are checked. The risk involved in selective verification gets considerably reduced in case the company has an effective system of internal control system. Selective the checking is more effective because it implies auditing in depth of a few selected entries rather than going through all the transaction superficially and hurriedly.

Selective verification, however, does not in any way reduce an auditor's liability. The standard of reasonable care and skill is applicable in all cases and one should see whether the extent of selective verification was reasonable so as to enable the auditor to form an opinion about the financial statements. So he has to undertake it in a scientific manner. If some suspicion is raised, he has to undertake a detailed verification programme. While undertaking selective verification, he should keep a complete record of the extent and the depth of the various tests carried out by him which may later prove to be useful against charges of negligence.

There are two techniques by which selective verification can be carried out. These are as follows :

A. *Test Checking :* It consists of selecting and checking an arbitrary percentage of transactions. For example checking 20 % of the postings from cash book to General Ledger or checking 100 % of the postings from cash book to General Ledger for any two months of the year, say March and April and so on. Test checking is normally conducted in a manner that the audit programmes for 3 to 5 years cover all types of transactions say, in one year one section of accounts is being thoroughly checked, in the second another section may be checked and so on. Another aspect of this approach is that it must contain an element of surprise. But test check is not a scientific approach as the determination of the number of transactions, their selection and evaluation is arbitrary.

B. *Statistical Sampling :* This is a scientific approach as it helps the auditor to determine the size of the sample, reduces the chance of arbitrariness or bias in selection of the sample and is capable of results with a calculated degree of risk.

Suppose, the auditor has to undertake confirmation of debtors through statistical sampling, then, he will first determine the size of the sample. Instead of just taking an arbitrary figure of 10 %, he would determine the sample size through statistical tables. These tables show different sample size depending upon how confident the auditor wishes to be regarding the accuracy of his sample. The auditor would then select the debtors account to be included in the sample on the basis of random number tables. Since he has to take only those accounts whose number is shown up by random number tables, there will be no element of bias in the sample and statistically the accounts so selected would be more representative of debtor accounts as a whole. Once the confirmations are received from the sampled debtors, the auditor can reach a more scientific conclusion with the help of statistical tables.

Thus it can be concluded that statistical sampling helps in a scientific verification of transactions on a selective basis.

Lesson 4

Vouching

The act of examining documentary evidence in order to ascertain the accuracy and authenticity of entries in the books of account is called "Vouching". In other words vouching means a careful examination of all original evidences that is invoices, statements, receipts, correspondence, minutes, contracts etc. With a view to ascertain the accuracy of the entries in the books of accounts and also to find out, as far as possible that no entries have been omitted in the books of accounts. According to Dicksee. "Vouching consists of comparing entries in books of account with documentary evidence in support thereof.

According to R. B. Bose, "By vouching is meant the verification of the authority and authenticity of transactions as recorded in the books of account".

From these definitions it is clear that vouching means testing the truth of entries appearing in the primary books of account, vouching includes routine checking of carry forwards, extentions, posting into the ledgers, casts, sub-casts and other calculations in the books of original entry. Vouching may be lengthy process in a big organisation unless there is efficient internal control system iiv existence.

The vouching is an important tool in the hands of auditor provided he handles this work with intelligence, observation and commonsense. Vouching is a sort of preliminary work which forms an important part of audit work. Since accounts of a business begin with the passing of entries, hence it becomes a basis for further scrutiny to be made at a later stage. The auditor, after satisfying himself with regard to the authority and authenticity of transactions, can only then say specifically that the books of account are correct and the Balance sheet and Profit and Loss Account exhibit the true and fair state of the financial affairs of business. This is why vouching is said to be the backbone of auditing.

But all this depends upon the efficiency of the auditor. He, besides checking the arithmetical accuracy of the books or comparing the entries with the available documentary evidence, should also go to the source of a transaction. He should also see that the transaction has been properly authorised. Frauds can be detected only by proper vouching conducted in an intelligent and searching manner. The importance of proper vouching was emphasised in the case of "Armitage Vs. Brewer and Knott . In this case auditors were found guilty of negligence because of their failure to detect defalcations committed by manipulating wage records and petty cash book.

Objects of Vouching

1. To see that all transactions connected with the business have been recorded in the books of account.
2. To establish that no transaction which is not connected with the business has been recorded.
3. To verify that all recorded entries are genuine.

Vouchers

A voucher is a written paper or document in support of an entry in the books of account. They may be of two types :

1. *Primary:-* A written evidence in original is said to be the primary voucher, for example, invoice for a purchase.
2. *Collateral:—* When the original voucher is not available, copies there of are produced in support or subsidiary evidence in order to remove doubt from the mind of auditor. Such a voucher is usually known as a collateral voucher.

A voucher may be a receipt, invoice wage-sheet, an agreement, correspondence, bank paying-in-slip, minute books recording resolutions of directors or share holders, and so on.

While examining vouchers the following points should be noted by the auditor:

1. All vouchers have been properly filed, serially numbered and arranged in order as it saves time in finding out a particular voucher in checking.
2. The voucher is properly stamped as normally every receipt for more than five hundred rupees requires a revenue stamp unless legally exempted.
3. The date and the year of the receipt or the voucher corresponding with the cash book. The name of the party to whom the voucher is issued, the name of the party issuing voucher and the amount etc. are correct.
4. Those vouchers which have been inspected by him are stamped so as to avoid the possibility of their being produced again.
5. Every voucher is passed "as in order" by some responsible person whose signature should be noted.
6. Amount paid appears both in words and figures. If they differ, the matter should be investigated.
7. For missing vouchers, the auditor should satisfy himself with regard to the reasons of their being lost. If he is not satisfied with the explanations, he should state this fact in his report.
8. No help from any member of the staff of the client has been taken while vouching the entries and checking the vouchers.
9. Any alteration in the voucher is duly signed by the invoice clerk.
10. In case of vouchers for insurance, rent, rates and taxes etc., the period for which the payment has been made should be noted.
11. Special attention should be paid to those vouchers which are in the personal name of one of the partners, Directors, manager, Secretary or any other official of a business and which may or may not relate to the business itself. In case of purchase, original invoice, inward book and order book etc. should be examined to ensure that the goods were purchased for the business only.

Vouching of Cash transactions

Vouching of cash transactions is by far the most important job in every business irrespective of its size and type of business etc. Before setting the programme for vouching the cash book, an auditor should examine carefully the whole system of internal check in operation in respect of cash transactions. (Internal check has already been explained in detail previously).

Vouching of receipts of the debit side of the cash book

It is rather very difficult to vouch the receipt of cash than to vouch payments as some entries might have been omitted altogether and therefore only an indirect evidence like counterfoils of receipts issued, carbon copies of receipts, contracts and letter from debtors etc. are available. He should check a few items at random and if he finds them to be in order, he may assume that the others will be correct but he must not forget to compare the rough cash book or the diary with the cash book. If he fails to do so and later on a fraud is detected, he might be held responsible. If he finds that there is a time gap between the two dates, he should go deeper into the matter as it is possible that money might have been received in between the two dates and misappropriated.

Some of the important items which usually appear on the debit side of the cash book and the duty of an auditor in that connection are given below:

1. *Opening balance:* This can be vouched by comparing it with the balance shown in the duly audited balance sheet of the previous year. By doing this, it is verified that the actual balance has been brought down.
2. *Cash sales:* Under this head, the chances of fraud are comparatively greater, for example the salesman may sell goods but may not record the same in the cash book thus misappropriating the money. Therefore the auditor should examine the effectiveness of the internal control system in operation in regard to cash sales. Assuming an effective internal check system in operation, the auditor should take the following steps to verify the correctness of the amount of cash sales.
   (a) Check the counterfoils of the cash sales books with the salesman's sun maries or abstracts.
   (b) Note that each salesman's abstracts agrees with the analysis of the cash received by the receiving cashier.
   (c) Check the details of cash received with the cash sales counterfoils.
   (d) Compare the daily totals of the receiving cashier's memorandum cash books with their corresponding entries in the main cash book. If the auditor fails to do so and later on fraud is discovered, he will be held liable.

Cash received from debtors

The cash received from customers to whom good have been sold on credit in the past can be vouched with the help of the counterfoils of the receipts issued to them. But it is often noted that a smaller amount than actually received is shown on the counterfoils or receipts are issued to the debtors from old but unused counterfoil receipt books, the auditor should take the following steps in vouching receipts from debtors :

1. Check the internal check system with regard to the sales as a whole.
2. Ensure that the unused counterfoil receipts are kept in safe custody.
3. See that all spoiled receipts are attached to the counterfoils and he has cancelled them.
4. Verify the dates on the counterfoils with those in the cash book.
5. The practice being followed with regard to receipts through cheques should be noted and if no official receipts are being issued, he should verify the daily lists of such receipts with the entries in the cash book.
6. In respect of discount allowed to debtors, the auditor should ascertain the terms on which discount is allowed and test check a certain number of entries to ascertain whether the discount allowed is in order.
7. Special attention should also be paid to the amount shown as bad debts written off as cash can be misappropriated by writing off the whole or a part of the debit balance as bad. He has to ascertain as to who is responsible for writing off debts as bad. He should, with the permission of the client, establish direct contracts with the debtors by sending them the statements or verification slips from time to time and asking them to send their confirmation directly to him.

With regard to receipts from debtors fraud may be committed by the process of "teeming and lading", that is not entering cash in the cash book received from a debtor and entering it only when a similar amount is received from another debtor and so on. Of course, no misappropriation is committed but the practice should be checked because there is the loss of interest for the period money is misappropriated and the

cashier may be tempted to commit such a fraud of bigger amount and may not be able to replace the same. To detect such a fraud the auditor should :-

1. examine the accounts of those debtors which show part payments from time to time.
2. check the amount and date on the counterfoil receipts to compare it with the date and amount deposited in the bank.
3. should send verification slips to the debtor requesting them to send the confirmation directly to him.

4. Bills receivables :

All details about bills receivable can be made available in the Bills receivable book. The auditor should take the following steps:

(i) Ascertain the due dates of the various bills.

(ii) Note that the amount due on bills was received on maturity. This can be ascertained by comparing the bills receivable book with the cash book and the pass book.

(iii) Special attention should be given to those bills which have been matured but the amount in respect thereof has not been received. Such bills might have been dishonoured or retired. But there is a possibility of their proceeds being misappropriated by the cashier.

(iv) In case of discounted bills, the cash received should be properly entered in the cash-book and the discount deducted should be separately shown in the discount account.

(v) He should note that in case of bills discounted but not matured at the date of the balance sheet, contingent liability has been shown in the balance sheet.

5. Rents Receivable :

The auditor should proceed keeping in view following points:

(i) examine the leases agreement with the tenants and ascertain the exact amount receivable.

(ii) Check the amounts due with the rent-foil.

(iii) Compare the amounts as per rent roll with the cash book.

(iv) Check the counterfoils of rent receipt issued to tenants. If agents are appointed to collect rent, the accounts or statements submitted by them should be carefully checked.

6. Interest and dividends :

Interest and dividends received from investments should be vouched in the following manner:

(i) receipts on this account should be checked with the counterparts of the interest and dividend warrants or the letters along with the cheques.

(ii) in case of bearer bonds the bonds themselves should be inspected along with the torn off coupons to note as to what interest should have been received.

(iii) If the banker is authorised to collect interests or dividends the entries in the bank pass book or statement should be inspected.

(iv) In case of interest on fixed deposits, the bank pass book has to be checked.

(v) In case of interest received on a loan granted to a borrower, the agreement between the borrower and the business should be referred to for the rate of interest, date of payment etc.

(vi) The auditor should ensure that all dividends or interest in respect of investments, deposits or lendings etc. have been received and accounted for.

7. Sale of fixed assets :

The points to be considered are given below :

(i) It is possible in case of sale of fixed assets, the sale deed is not executed for the full purchase consideration. To detect such a fraud, the auditor should examine the correspondence made with the parties willing to purchase them.

(ii) In case, sale has been made through a broker, the broker's sold note should be examined,

(iii) He should see that the sale has been duly sansctioned.

(iv) He should note that the profit earned on the sale of fixed assets should be credited to the capital reserve account and not to the general profit & loss account.

8. Insurance Claims :

Amounts received under an insurance policy should be verified by means of the correspondence with and accounts rendered by the insurance companies.

9. Sale of investments :

In this connection, the auditor should consider the following points:

(i) As investments are usually sold through brokers, so the broker's sold note should be examined to note the date of sale, the amount received and the commission changed.

(ii) In case the sale has been made through the bank, the bank advice should be examined.

(iii) He should note as to whether the sale has been cum-dividend and if so, the dividend has subsequently been received and the sale proceeds have been proportioned between capital and revenue. If investments are sold ex-dividend, he has to see that the dividend has been received if declared.

10. Subscriptions :

Subscriptions received by a club or society should be checked with counter-foils of receipt books and with the published list of subscribers.

11. Commission received :

For this, the agreements between the client and the parties from when it is receivable should be examined to verify the terms of commission, its rate etc. Counter-foils of receipts should be compared with the particulars entered in the cash bank. In case of goods received on consignment, the amount of commission should be vouched with reference to the copy of the account sent to the consignor or the auditor should calculate the amount himself, if necessary.

12. Receipts from hire purchase :

The hire purchase agreement should be checked in order to ascertain the duration of the agreement, the amount of instalments, total number of instalments, payment by the close of period the accounts of which are under audit. He should also note that the instalment includes interest also and also the whole amount of an instalment is properly apportioned between sales and interest.

Vouching of Cash Payments

The object of vouching the credit side of cash or bank of cash payments is not merely to ascertain that money has been paid away but to ensure that the payments have been made :

(a) to the proper and right party,

(b) on behalf of the business for a proper purpose,

(c) for the accounting period under audit,

(d) after proper authorisation,

(e) against a proper voucher, and

(f) correctly recorded in the books of account.

Some of the important items on the credit side of the cash book and the duty of an auditor in that connection are given below:

(A) Capital expenditure :

According to Spicer and Pegler "Capital expenditure is all expenditure incurred for the purpose of acquiring, extending or improving assets of a permanent nature, by means of which the business may be carried on or for the purpose of increasing the earning capacity of the business". Such expenditure is normally heavy and therefore require special attention. The type of documents required depends upon the nature of the payment. Some of the items of capital nature and the duties of an auditor in each case are given below :

1. Land & Building : The auditor should take the following steps :

(i) The documents of title of the property purchased should be examined.

(ii) The auditor should find out as to whether land or buildings purchased are on freehold or leasehold basis. In latter case, he should examine the terms of the lease.

(iii) If the properties are purchased through an auctioneer, the account submitted by the auctioneer should be checked.

(iv) In case the property has been purchased through the broker, the broker's note should be examined.

(v) Where the property is got erected through a contractor, he should examine the receipts issued by the contractor, for payments made. If the buildings have been constructed by engaging labour, he should vouch the expenditure on building materials purchased, cartage paid, wages paid to the workers etc. and also see that the expenditure has been properly capitalised.

(vi) The expenses incurred, for example, auctioneer's commission, brokerage, architect's fee, registration fee etc. can be vouched with the help of the receipts obtained and it should be seen that they are capitalised.

2. Plant, Machinery, Furniture, Fixtures etc. :

In this connection, the auditor should take the following steps :

(i) examine the invoices and the receipts obtained from the supplier and see that the items have been properly authorised.

(ii) In case, machinery has been purchased on hire-purchase basis the auditor should examine the contract of hire-purchase with the vendors to find out the purchase price, the amount of instalment and interest. Here, he should note that only the principal amount has been capitalised.

3. Investments :

Investments should be vouched in the following manner:

(i) In case, these have been purchased though a stock-broker, payments should be vouched with reference to the brokers sold note.

(ii) In case of a new issue for which application has been made and if the share certificates have not yet been received, the allotment letter and banker's receipts for the instalments paid should be inspected. But if share certificates or debentures have been received, they should be examined.

(iii) The actual investments should be examined.

(iv) In case of cum-dividend purchase, he should see that the expenditure has been properly apportioned between capital and revenue.

(v) He should see that the investments have been made in accordance with the provisions of the Companies Act and Investments are registered in the name of the company required under section 49 of the Companies Act.

4. Patents :

The auditor should take the steps as given below :

(i) examine the patent.

(ii) if the patent has been purchased, the assignment should be inspected together with the receipt for the purchase consideration.

(iii) In case patent has been purchased through some agent, the agent's receipted amounts should be examined to note the agent's fees and verify the amount so included in the asset account.

(iv) He should note that the patent renewal fees has not been charged to the patent account, as these fees represent revenue expenditure.

5. Loans :

In order to vouch the figure of loans, the auditor should :

(i) inspect the loan agreement, the security held if any, receipt given by the borrower etc.

(ii) examine that the loan has been properly authorised.

(iii) If the loan has been advanced against mortgage he should examine the receipt mortgage, the receipt from the borrower, the mortgage, deed, title deeds and other documents.

(iv) In case of loans to directors, the managing directors and other officials of a company, he must see that the provisions of the companies act are followed.

(B) Revenue Expenditure :

(i) *Wages:* In case of concerns employing a considerable number of workers, vouching of wages forms a very important part of the auditor's job. He should first of all satisfy himself in regard to the efficiency of internal check system so far as it relates to the maintaining of wage records, preparation of wages sheets and payment of wages. Besides this, he should note the following points:

(i) the totals and calculations involved in the wage sheets should be checked.

(ii) He should check a few items, for example, deductions in the form of rent, fire insurance, providend fund, etc. and the method of deducting them should also be examined.

(iii) He should see that the amount of the cheque drawn for payment of wages tallies with the net amount as shown in the wages sheets.

(iv) Names of workers given in the wages sheets should be well compared with those given in the wages record like job cards, foremen's register, etc.

(v) He should see that the wages sheets have been properly initialled by those responsible for their preparation.

(vi) He should carefully check the payments made to the casual labour.

2. **Salaries :**

For this, salaries book containing the details of the employee's salary should be maintained. The auditor should take the following steps :

(i) He should compare the cheques drawn with the salaries book.

(ii) Any change in the salary list should be verified with an official source.

(iii) Special attention should be paid to the deductions in respect of provident fund, life insurance premium, income tax, etc.

(iv) Independent information as regards employees leaving the service of the concern should be obtained from the staff departments and compared with the salaries book to find out persons already left being included in the salaries book.

(v) He should ensure that the payment has been made to the correct person. This he can do by comparing the signature on the salaries book with the specimen signature of the employees.

3. Petty Cash :

Vouching petty cash is another problem for the auditor as normally there are no proper vouchers and therefore chances of misappropriation of cash exist. As a first step, the auditor should examine the soundness of internal check system in this regard and in case he finds it to be satisfactory, he should take the following steps :

(i) He should see that imprest system is being followed and if not he should recommend the same to the client.

(ii) He should check the payments made to the petty cashier with the entries in the cash book.

(iii) For those expense for which vouchers are not available he should ask the petty cashier to give a summary which should be duly signed by a responsible officer.

(iv) He should examine the totals and balances of the petty cash book.

(v) He should see that the petty cash book is periodically checked and initialled by some responsible official.

(vi) The auditor should, without notice and occasionally, count the cash in hand and agree it with the balances shown by the petty cash book.

4. Travelling expenses

These are paid for the travel in connection with the business. Where a fixed amount is payable, there is no difficulty in checking it. But in other cases, the auditor has to check very carefully. His duty in vouching such payments shall consist of:

(i) Vouching the cheque drawn according to the cash-book with the traveller's receipts.

(ii) Checking the figures in some of the traveller's accounts with the vouchers submitted by them.

(iii) Seeing that all unpaid commissions and expenses have been brought into account at the end of the financial period.

5. Insurance premiums

In case of new policies, the auditor should inspect the cover note or the receipt from the insurance company and in case the policy has been received, it should be examined. In case of renewals, the renewal receipt should be checked. If the number of policies is large, he should require a schedule of various particulars like number of the policy, the amount, the date of maturity, the amount of the premium payable

etc. He should examine these particulars. In case some policy has lapsed, he should find out as to under whose authority it has been allowed to lapse.

6. Bank Charges

In order to vouch this item as shown in the cash book the auditor should tally the figures with the bank pass book and if necessary he should check their calculations.

7. Postage

The auditor should compare the postage book with the cash book and petty cash book and count the stamps in hand. He should see that postage includes only the postal expenses connected with the business and not with any private account.

8. Director's Fee :

The auditor should take the following steps in vouching the payments under this head,

(i) Examine the articles to find out the fee payable to the directors.

(ii) The director' s minute book, the attendance register should be examined to ascertain the number of meetings attended by them.

(iii) Examine the receipts obtained from directors for this payment.

(iv) Examine the resolutions of the shareholders to calculate the amount payable as director's fee and compare this figure with the amount actually paid.

9. Cash Purchases

In vouching this item, the auditor should take the following steps :

(i) Test the entries in the cash book with the cash memos.

(ii) See that the goods paid for have actually been received which can be done by checking the entries in the goods inward book or purchases book.

(iii) See that only net amounts, that is, purchases minus trade discount, has been carried to the books of account.

10. Payments to Creditors

(i) The receipts issued by the creditors acknowledging the receipt of money should be checked.

(ii) The money paid should be compared with the money due as per the accounts of the creditors and the invoices received from them.

(iii) He should scrutinize the method of comparing the statement of accounts with their actual accounts.

(iv) Before passing an entry in this regard, he should refer to minutes, contracts and other documentary evidence in support of it.

11. Bills Payable

In this connection, the auditor should:

(i) Examine the duly cancelled returned bills as an evidence of the amount having been paid.

(ii) Inspect the bills payable book.

(iii) See the bank pass book and the banker's advice in case the payments on certain bills have been made through the bank.

12. Freight and Carriage

The auditor should vouch the payment on this account with the help of the statements rendered by the shippers or carriers together with the receipts. He should also see that allowances in respect of rebates have been properly accounted for.

13. Rents Payable

The agreement with the landlords and receipts from them should be examined.

14. Payment of taxes

In order to vouch this item, the auditor should refer to the copy of the assessment order, assessment form, notice of demand and the receipted challan etc. The advance payment of income tax and interest allowed on it should also be verified. Payment of sales tax can be vouched by reference to the return submitted by the dealer and Treasury or bank receipt every month or quarter.

15. Commission

The conditions relating to the payment of commission should be examined with reference to the agreements between the client and the agents. The statements of account submitted by the agents should also be seen.

Vouching of Trading Transactions

Here, the auditor is concerned with the checking of the Purchases Book and Sales Book in order to prevent misappropriation of goods.

1. Purcahse Book or Bought Day Book : This book is used for recording the credit purchases of the business only. First of all, an auditor should satisfy with the internal check system in operation with regard to purchases. If the system of internal check is efficient and effective, the auditor can conveniently proceed with the vouching of purchases book in the following manner:

1. He should check the invoices and compare them with entries in the day book. When examining an invoice, special attention should be paid to the following points :
   - (a) The name of the creditor agrees with the entry in the day book.
   - (b) The invoices are made cut in the name of the auditor's client and appear to be of a nature relating to the business carried on.
   - (c) Each invoice relating to goods has a memorandum, signed by the gate keeper acknowledging receipt of the goods attached to it. Alternatively, it may bear a reference to a goods inward book. The auditor should examine these order to see that the goods stated in the invoice have actually been received.
   - (d) The date agrees with that in the day book and falls within the period under audit.
   - (e) The trade discount has been deducted from the amount of the invoice, then only net amount has been entered.
   - (f) Any invoice charged to capital is a proper capital charge and is debited to the correct account.
   - (g) In case the staff member's accounts are passed through the day book, they are charged to their personal accounts.
2. At the end of the financial period, the auditor should compare the goods inward book and the stock sheets with the purchases book in order to ensure that all goods taken into stock have been entered in the purchases book. In case there is no goods inward book, he should check the suppliers advice notes received with the goods as it is possible that towards the close of the financial year, goods have been received and included in that closing stock but not recorded in the purchases books which will inflate profits.

3. The auditor should ask his clients to send notice to every supplier requesting him to furnish a statement showing the balance due on the balance sheet date. Then he should examine these statements and compare them with the ledger accounts. If they agree, it will mean that no invoices with regard to these accounts have been omitted.

4. The auditor should see that no invoice has been entered twice in the books as fraud may be committed by such a practice. In order to prevent it, he must compare invoices and the goods inward book in few cases as test checking.

5. As invoice may be post dated to provide a fictitious period of credit to the purchaser the auditor must see that entries are made in the purchases book only if the goods have been actually received during the financial year under audit.

6. In case of duplicate invoices, the auditor should satisfy himself that they were obtained in respect of only these invoices which have been actually lost.

7. He should check totals, sub-totals, carry-forwards, calculations in the purchase books and postings from the purchases book to the ledger accounts.

2. Purchases Returns Book

Sometimes goods purchased are rejected or returned to the supplier or seller for various reasons. In this connection the auditor should satisfy himself with the efficiency of internal check system and if satisfied should proceed in the following manner.

1. He should compare the credit notes sent by the creditors with the entries in the purchases returns book and the goods outward book.

2. He should see that proper deduction has been made on account of goods returned before the payment is made. In case the payment has already been made, he should ensure that full credit has been received subsequently.

3. He should pay particular attention to the heavy returns made at the close of the year and in the beginning of the year as the entries might have been passed to adjust fictitions purchases of the previous months.

4. He should check castings and postings of the purchases returns book to the ledger accounts.

3. Sales Book (Credit Sales)

The vouching of the sales book is a much more difficult task then that of the purchase book because the only documentary evidence available is in the form of duplicates or invoices which are not completely reliable. Therefore the auditor has to be very careful in this regard. Firstly, he should examine the system of internal check in this respect and if satisfied with the system, proceed as follow:

1. He should compare the various particulars like the name, date, amount etc. on the copy of the invoice with those given in the sales book.

2. In case some distinction is made in granting trade discount to two different customers, he should enquire into the reasons for the same.

3. The sales book should be vouched with the help of the orders received book and the goods outward book to ensure that no sales have been omitted from recording.

4. Where goods have been supplied on ‘approval’ or ‘goods on sale or return’ basis, he should see that they are not treated as sales till the letter of acceptance has been received. At the same time he should ensure that the goods with customers are included in the stock.

5. The auditor should specially examine the sales relating the sales relating to the periods in the beginning or at the close of the financial year in order to ensure that no manipulation has been made in accounts. He may check such sales with the goods outward book.
6. He should see that capital sales have not been treated as revenue sales.
7. He should check the castings of the sales book and the posting to the ledger accounts.
8. He should set that the goods sent on consignment are not included in the figure of sales. They shall be treated as sales only when they have been actually sold by the consignee and the 'Account Sale' is received by the consignor. Till then, such goods are to be treated as stock with the agent. So he should check such entries with the consignment note, account sale, vouchers for the expenses and cash-book. Entries for sale-proceeds, expenses incurred by the consignee, his commission, etc. should be vouched with the help of account sale as sent by the consignee. He should also see that the stock remaining unsold with the consignee is shown in the balance sheet at cost or market price whichever in lower.

Sales Under Hire Purchase Agreements

Such sales can be recorded in the account books under two methods. One is to credit the sales account with the total cash selling price in the year of sale and to treat the buyer as debtor for the instalments not yet due at the date of the balance sheet. The other is to credit the sales account with each instalment payable under the contract as and when it becomes due. When the first method is followed the auditor should see that a provision for unrealised profits is made at the date of the balance-sheet and credit is taken in each year only for such interest as has actually accrued during the accounting period. In case the second method is adopted, the auditor should see that the amount of the unpaid instalments less unearned profit included therein, is credited to the trading account and shown in the balance sheet as stock-on-hire.

Packages and Empties

There are some cases in which customers are supplied with packages like bags, cans and jars etc. which they have to return to the suppliers or dealers. The auditor shall see that an effective system should exist to record such packages and empties. Generally a memorandum system is adopted under which the customer is debited with the cost of such empties. The cost of empties is not included in the sales. They are entered in the sales return book under a separate column for this and also in the empties returns inward book by the gatekeeper. So the auditor must examine these books.

At the date of the balance sheet a list of empties 'not returned' by the customer should be prepared and the value of such empties should be recorded in separate book to be known as "Empties and Packages on hand" at cost price less depreciation. So the auditor should ensure a proper valuation of empties for the purpose of balance sheet and see that correct depreciation has been provided for those packages and empties which are still in the hands of the customers.

5. Bills Receivable Book

Entries for bills receivable are passed in this book. Auditor's duty in regard to different types of bills is as follows:

(a) In case of bills matured for which payments have been received, the receipt of money may be checked by reference to the cash book or bank pass book as the case may be.

(b) For bills discounted, the cash book and the pass book entries should be checked.

(c) There may be bills in-hand which are not matured. If such bills are with the client,, personal verification should be done by the auditor. If they are deposited with the bank, the auditor should check the certificate to that effect obtained from the bank.

(d) In case of bills dishonoured, he should see that the proper entries have been passed in the financial books. He should also check the castings of the bills receivable book and their postings to the ledger accounts. The liability for bills discounted should be properly shown on the liability side of the balance sheet.

6. Bills Payable Book

The auditor's duty in connection with bills accepted and entered in this book is as follows :

(a) In case of those bills for which payment has been made by the client on maturity, the auditor should vouch them with the entries in the cash book or bank pass book and the returned bills.

(b) For those bills which have not yet mature, he should vouch them with the help of counterfoils or copies of such bills, bills payable book and if necessary, the statements of account submitted by creditors.

(c) He should also examine the castings of this book and their postings into theledger accounts.

7. Journal :

Journal is used to record all extra ordinary transactions for which there are no special books of original entry. The entries appearing in the Journal will be such as all opening entries, say, for the acquisition of various assets, the issue and allotment of shares etc., closing entries which are passed" for closing and transfering balance from the nominal accounts in the Profit and Loss account; adjusting entries such as provision for outstandings, depreciation and bad debts etc, and miscellaneous items like writing off profits or losses on the sale of assets. In order to vouch the journal the auditor should take the following steps :

1. In order to vouch opening entries, the auditor should examine them with reference to last year's audited balance sheet. In case of new business he should verify them with reference to minutes of the board's meetings, documents of title, purchase agreement, correspondence with the vendors, receipts issued by the payee, etc.
2. For vouching closing entries, he should see that balances were correctly arrived at and they have been carried to proper accounts.
3. In case of adjusting entries the auditor should check all the available evidence, for instance, bad and doubtful debts can be inspected with the help of accounts contained in the sales ledger.
4. He should check the postings to the respective ledger accounts to as certain that they are in order.

8. Bought Ledger or Purchase Ledger

This ledger contains accounts relating to creditors. The auditor should take the following steps:

1. He should check the opening balances of different accounts with the audited balance sheet of the previous year.
2. He should examine all supporting books like purchases book, goods inwards book, cash book, discount register, goods outward book etc.
3. If the self- balancing system is in use, he should ask his client for a schedule of creditors and total of the schedule should be tallied with the creditor's ledger adjustment account.
4. The auditor should examine all the creditors statements and with their help, the purchase ledger balances should be checked.
5. He should see that the balances in the purchases ledger whether debit or credit are shown on the proper side of the balance sheet.
6. He should ensure that provision for reserve for discount on creditors, if made, is not excessive.

9. Sales Ledger or Debtors Ledger

This contains accounts relating to debtors. The following points should be noted while vouching sales ledger:

1. The auditor should check the opening balances with the audited balance-sheet of the previous year.
2. He should examine supporting book like bills receivable book, cash-book, goods out ward book, sales returns book etc.
3. Where self-balancing system is in use, the total of the balance as per the schedule of debtors should be verified with the total of the balance shown in the debtors ledger adjustment account.
4. He should test check postings to this ledger from various books of first entry. He should give special attention to credit postings, as any attempt to conceal defalcations will more usually take the form of fictious credit entries.
5. He should also check the castings and balances with the list of debtors. If there is any credit balance in the sales ledger, he should see that it is shown on the liabilities side of the balance sheet alongwith sundry creditors.
6. While examining the accounts the auditor should ascertain the composition of each balance. In particular he should note whether it represents specific items of goods or is an accumulated balance. In the latter case, he should ensure that it does not represent doubtful for bad debt.
7. He should call for a list of bad and doubtful debts and verify them thoroughly as there is quite possibility of the figure being understated and misappropriated.

Vouching of Impersonal Ledger :

It is an important part of the auditor's, duty to vouch the impersonal ledger which contains accounts from which trading and profit and loss accounts and the balance sheet are prepared. The impersonal ledger has two kinds of accounts -Nominal accounts & real accounts. Nominal accounts relate to the trading, profit account and real accounts record assets. Here, the transactions appearing in the impersonal ledger but relating to profit & loss account and the auditor's duty in connection with only those items is to be considered. Whole vouching these transactions, the auditor should consider the following points :—

1. He should check the totals of the various books of original entry with the accounts in the impersonal ledger.
2. He should vouch the Journal carefully and should see that each entry is supported by sufficient evidence. He should also check their postings to impersonal ledger.
3. He should test the postings from the cash book to the impersonal ledger in order to ensure that the entries have been posted to the correct accounts.
4. In those cases where direct entries are passed from one account to another in the impersonal ledger, he must proceed in the same manner as if they had been passed though the journal. Such items are as follows :

1. Outstanding assets :

Under this head, there may been an expenditure already incurred for which the corresponding benefit could not be made available for the business during the period or some portion of this relates to the period subsequent to the date of balance sheet. Such items are usually named payments in advance or pre-payments and should be shown in the balance sheet.

Beside this, there may be some items accruing or due which may not have been recorded in the books, for example, prepaid expenses, accrued income items and deferred revenue expenditure. In case of prepaid expenses like advance payment of rates and commission etc ; the auditor should see that such amount has been excluded from the profit & loss account and be shown on the asset asset side of the balance sheet. He should vouch such expenses with the help of nominal accouifrs, demand notes, receipts and the actual inspection of the original documents. He should also see that the correct amount has been proportioned between the two periods on the date of the balance sheet. In case of other items also, same procedure can be following by the auditor.

2. Outstanding liabilities :

It is the duty of an auditor to ascertain that all outstanding liabilities are brought into account before calculating the net profit or loss for the year under audit. But in practice, it may not be easy for an auditor, therefore it is better if he obtains a certificate from a responsible official that there are no expenses incurred in the current year which have not been recorded in the books of account. In spite of this, he should scrutinise the nominal accounts like interest, rent and salaries and discount etc, to verify that all expenses accrued up to the date of the balance sheet have been accounted for.

For example in case of unearned income, the auditor should examine the necessary vouchers to ascertain how much amount of such income is to the credited in the current year's profit and loss account and how mcuh is to be carried forward to the following year. Another example of outstanding liabilities is unpaid expenses such as audit fee wages and salaries, freight & carriage, rent, rates, taxes & electricity etc. traveller's & agent's commission, interest on loan & debts etc. In order to vouch these expenses, the auditor should examine nominal accounts demand notes, receipts, invoices & other relevant vouchers & note the period covered by such payment. He should also ascertain with their help that the expenses unpaid have been debited to the profit & loss account of the current year and shown separately on the liability side of the balance sheet.

3. Contingent liabilities :

Contigent Liabilities are those liabilities which are not definite or certain as they may or may not arise after the preparation of the balance sheet. So it is the duty of an auditor to see that the necessary provision has been made for contingent liabilities. In order to ascertain the existence of such liabilities, he should examine the minutes of the meetings of the board of directors and other concerned correspondence. He should also enquire from the legal officer of the client about possible losses from pending law suits. He should write to the bank to supply a list of all the bills discounted, also the number of bills which have not matured as yet. He should also find out the amount of dividend payable to cumulative share holders. The auditor should divide the contingent liabilities into two main groups according to Part - I of schedule IV of the companies Act. First come those liabilities in respect of which a provision has been made in the balance sheet. So in such a case, he shpuld see that they appear under the heading "current liabilities and provisions". Then there are liabilities in respect of which no provision has been made in the balance sheet. In this respect, the auditor has to see that these are appearing by way of foot note in the balance sheet.

4. Contingent Assets

There is no practice of showing these in the balance sheet either as a foot note or any other manner and in Companies Act also there is no provision to show them. It is but fair that if a contigent liability is shown, a contingent aseet must also be shown at the same time.

Lesson 5

VERIFICATION

Verification means 'proving the truth' or 'confirmation'. One of the most important duties of an auditor in connection with the audit of the accounts of a concern is to verify the assets and liabilities appearing in the balance sheet. The fact that there is an entry regarding the purchase of an asset and has been be correctly recorded, is not a proof that the asset is in the possession of the concern at the date of the balance sheet. It is possible that after purchase and passing the entries, the asset might have been disposed of or pleadged and no entry has been made concerning this before the closing of thse books. Therefore, he has to see whether a particular asset as recorded in the balance sheet on the day of the closing of the books of account exists or not. If he fails to verify the asset, he will be liable for any damage suffered by the client as it was decided in the case of London Oil Storage Co. Ltd. Vs. Sear Haslock and Co. (1904).

Thus we can say that verification is a process by which the auditor satisfies himself not only about the actual existence, possession, ownership and valuation but also ensures that the assets are free from any charge or lien. The verification of assets involves the following points :

1. Comparing the ledger accounts on the date of the balance sheet.
2. Verifying the existence of the assets on the date of the balance sheet.
3. Satisfying that they are free from any charge of mortgage.
4. Verifying their proper value.
5. Assets were acquired for the business.

Difference between Vouching and Verification

1. Vouching is based only on documentary evidence whereas verification is based on physical inspection as well as documentary examination.
2. Vouching examines the entries relating to the transaction recorded in the books of account whereas verification examines the assets and liabilities appearing in the balance sheet.
3. Vouching of books of account is done for the transactions for the whole year. Verification, on the other hand is done at the end of the year when the balance sheet has been prepared.
4. Vouching indicates though a particular asset must be in possession of the concern whereas verifies certifies the existence of the asset.

The auditor should as far as possible, inspect the assets personally on the date of the balance sheet like cash, bills receivable and investments etc.

Verification of assets is important as it will avoid the possibility of the improper inflation of values, or of the existence in the books of record of an asset which does not exist or which in fact never existed. This may be done in most of the cases to inflate the profits, and to show a better position of the business than what is actually is. An example of this is inflation of the value of stock. If the auditor is negligent is performing his duties in respect of verification, he may not be in a position to detect misappropriation of assets, inflation of profits and falsification of the balance sheet. In such case he may be held liable for damages.

Valuation

Valuation of assets is an important part of their verification. The correct profits can not be calculated unless the assets are properly valued. Only then the balance sheet will reveal the true and fair position of the financial affairs of the business. The valuation as such is to ensure the correct valuation of the assets while in verification, the auditor has to verify the authority, and the existence of the property also besides its

valuation. Thus valuation means to test the exact value of an asset on the basis of its utility. Normally, valuation is done after deducting the depreciation for the value of an asset. If proper depreciation on assets is not provided for, the profits will be overstated or understated which will have adverse effect on the company's solvency. The auditor should consider the following points while valuing the assets:

1. Original cost of the assets.
2. Expected working life of the assets.
3. Wear and tear of the assets.
4. Break-up value of the assets.
5. The chances of the assets becoming obsolete.

Mode of valuation of different types of assets.

The mode of valuation of different types of assets differs depending upon the nature of the business and the purpose for which the assets are held. The basis of valuation for different types of assets is given as below :

1. *Fixed assets :* These assets are of a permanent nature with which the business is carried on and which are held for earning income and not for re-sale in the ordinary course of the business. For example, land and building, plant and machinery and furniture etc. These assets are to be valued at cost price less total depreciation in their value by constant use. Additions and sales should be taken into account.
2. *Wasting Assets :* These assets are of fixed nature and are depleted gradually lose a part of their value in the process of working such as mines, quarries and oil wells etc. The common method of valuation in such a case is that the value of such assets must be shown in the balance sheet at its original cost and provision is made for depreciation and depletion according to the estimated exhaustion of these assets.
3. *Intangible assets :* There are the assets which have income producing ability but can not be seen of touched. For example, goodwill, patents, copyrights, licences etc. They are generally valued in the same manner in which fixed assets are valued, that is at the cost price.
4. *Current Assets :* These are the assets which are acquired in the business held for purposes of consumption, resale or subsequent conversion into cash. For example, stock-in-trade, book-debts, cash and bills receivable etc. These assets should be valued at original or the market price whichever is lower.

Auditor's position as regards valuation of assets : It is not an auditor's duty to determine the values of various assets. It has been judicially held that he is not a valuer or a technical man to estimate the value of an asset. But he is definitely concerned with values set against the assets. He has to certify that the profit and loss account shows true profit or loss for the year and balance sheet shows a true and fair view of the state of affairs of the company at the close of the year. Therefore he should exercise reasonable care and skill, analyse all the figures critically, inquire into the basis of valuation from the technical experts and satisfy himself that the different classes of assets have been valued in accordance with the generally accepted assumptions and accounting principles. If the market value of the assets are available i.e., in the case of share investment then he should verify the market value with the stock exchange quotations. If there is any change in the mode of the valuation of an asset, he should seek proper explanation for it. If he is satisfied with the method of valuation of the assets he is free from his liability.

Verification and Valuation of assets

1. Property : In order to verify this item, the auditor should distinguish between two types of property.

(a) *Freehold Property :* Where Freehold property has been purchased, he should examine the title deeds e.g., the purchase deed, the certificate of registration, the broker's note and the auctioneer's account etc., in order to verify the correct position. However, an auditor cannot guarantee that the title is good, all he can do is to see that the deeds are in client's possession and appear to be in order. In case of any doubt on any point, he should refer the matter to the client's solicitors.

In case where property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed and outstanding amount of loan. In case the property has been acquired in the current year the cost may be verified with the help of the bank pass book. He should also vouch all the payments made in this connection. He should see that the property account should be shown in the balance sheet at cost price including the legal and registration charges less depreciation up-to-date. He should also see that a separate account for building and land on which it is constructed is maintained. It is necessary because depreciation is provided for building and not for the land.

(b) *Leasehold Property :* The auditor should verify this by inspecting the lease contract to find out value and duration. He should see that the terms and conditions of lease are properly complied with. In case property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed. Where the leasehold property has been sub-let, the counter part of the tenant's agreement should also be examined. Wherever possible, the auditor should physically inspect the properties. He should also note that proper provision has been made for depreciation of leases and for any possible claims arising there under.

2. Furniture, Fixtures and Fittings : In case the assets have been acquired during the current accounting period, the auditor should examine the invoice of the dealers. It should be noted that adequate depreciation has been written off, based upon the working life. In the case of fixture and fittings on lease hold premises, the whole cost should be written off over the period of the lease of their estimated working life, whichever is shorter. A stock register to record furniture etc., purchased should be maintained. The old and unserviceable furniture must be discarded by a responsible officer. He should ask the management to prepare an inventory and reconcile it with the stock register.

3. Plant and Machinery : In case the machines are purchased in the current accounting period, the invoices and the agreement with the vendors should be verified. The auditor should ' examine the plant register in which particulars about the cost, records about sales, provision for depreciation, etc., are available. He should prepare a list of each machine from the plant register and should get the list certified by the works manager as he is not a technical man and therefore he has to depend upon the advice of the works manager regarding their valuation, etc. He should see that plant and machinery account is shown in the balance sheet at cost less depreciation after making proper adjustment regarding purchases and sale of some parts effected during the year under audit. In case any plant and machinery has been scrapped, destroyed or sold, he should ascertain that the profit or loss arising thereon has been correctly determined.

4. Goodwill: Goodwill should be shown as an asset in the balance sheet only if it has been purchased. In such a case goodwill should be shown at cost. But if the price paid for goodwill has not been fixed specifically in the contract of sale, the amount of goodwill will be the difference between the total purchase price and the other assets at agreed valuations, less any liabilities taken over from the vendors.

Here it should be noted that the real value of the goodwill of any business can be said to fluctuate almost daily and it is not part of an auditor's duty to consider whether this value is greater or smaller that its book value at a balance sheet date. The auditor should see that the goodwill account represent the actual cost only, that is, improper items should not have been included therein.

Sometimes a question is raised about the depreciation of goodwill. Legally, it is not binding on a company or a firm to write off goodwill, but, however, it is advisable from the financial point of view to write

it off gradually within a reasonable period out of current profits or reserves. But it is for the proprietors or directors to decided. An auditor cannot interfere with this decision, though he may give advice, if asked for. However the auditor should very carefully look to the reasonableness of appreciation in its value, if any.

5. Patents : The auditor should first of all examine the patents and verify them with the help of the certificates which have granted for such patent rights. Where the patent has been purchased, the assignment as well as the patent should be inspected.

If the number of patents is considerable, the auditor should call for a schedule thereof from the client giving particulars of each patent the register number, dates etc. and examine the same.

Here it is important to note that the actual patent should be examined and it must be duly registered. He should also examine the last renewal fee receipt to satisfy himself that the patents have been renewed at the prescribed time. He should note that the cost of renewal fee should be debited to profit and loss account.

6. Trade Marks : The auditor should see that they are registered in the name of the client and this can be done by examining the certificate issued by the Registrar. In case a trade mark has been purchased he should also vouch the payment.

Where it is registered by the proprietor of the business himself he should examine the registration documents and the certificates issued by the office of the registrar of trade marks and the last renewal payment fee receipt. He should also see that any expense incurred in the acquisition of the trade mark has been treated as capital expenditure but any renewal charges has been treated as revenue expenditure.

7. Copyrights : This is a right to produce or re-produce some kind of literary works. Its effect is that the author or the publisher gets an exclusive right to publish or reproduce the work for a certain number of years of for the life time of the author or the publisher as the case may be the auditor should inspect the agreement between the author and the publishers. It is after seen that the value of the copyright is not stable because they lose their value by passage of time. Hence, in this case, the revaluation method of charging depreciation is considered to be most appropriate. The auditor may rely on the certificates of experts responsible for revaluation.

If the sale of the publication is very low or nil, the copyright should be written off. Generally, copyright must be shown at cost less amounts written of from time to time.

8. Loose Tolls : The auditor should obtain a list of loose tools duly authorised by some responsible officer and examine the same. Revaluation of loose tools is the most appropriate method of valuation. The difference between the cost price and the current price should be treated as depreciation or loss to be charged to the profit and loss account.

9. Motor Vehicles : Motor Vehicles account is to be separately maintained. The auditor should compare it with the balance sheet in which it should be clearly stated under separate head. He should also see that they are shown in the balance sheet at cost less depreciation.

If the number of vehicles is very large, a separate register maintained should be checked and compared with a schedule of motor vehicles by the auditor. He should check the registration books and licences to ascertain that vehicles are registered in the name of client. He should check the premium receipts to ensure that they are fully insured.

10. Investments : Investments include government securities, shares, debentures, etc. When the number of investments is very large, the auditor should ask for a schedule of investments held by the client containing various particulars like name of the securities, date of purchase, nominal value, cost price, market

price, etc., and examine the same. He should see that the asset has been shown separately in the balance sheet.

The auditor should verify the existence of investments by his personal inspection. At the same time, he should also ensure that the investments are registered in the name of the client and they are free from any charge. He should rely on the relevant vouchers and certificates to do so.

If the securities are with the trustees on behalf of the concern the auditor should examine the trust deed. In case they are under the safe custody of the banker then he should obtain the certificate from the banker and examine the same. If they are with the broker, he should examine the certificate received from the broker.

Having verified the securities, the auditor has to find out that the investments are properly valued. Generally, investments are valued at cost price of market price whichever is lower. In case there is a temporary fall in the price of the shares, it should be ignored. But where such a fall is permanent, depreciation must be provided. Actually the basis of valuations of investment will depend upon the purpose for which they are held. For instance, in case of trust company the sole purpose of which is to earn interest and dividend, then such investment must be treated as fixed asset. In such cases even the permanent fall in their value should be ignored.

11. Book Debts (Sundry Debtors) : The task of verifying this asset would be reduced to a great extent in case there is an efficient internal check system regarding sales and writing the sales ledger. The auditor should, however take the following steps to verify this asset:

1. He should see that the debts as disclosed in the balance sheet are recoverable.
2. He should obtain a certified statement of book debts clearly distinguishing between good debts, secured debts, unsecured debts, current debts, bad and doubtful debts, debtors outstanding for a period exceeding six months and other debts.
3. He should check the balances of the sales ledger with the schedule of the book debts by test checking.
4. In case where certain amounts of debt has been written off the auditor should enquire into the details. He should also examine the correspondence or any documentary evidence or the authority of any insolvency court regarding the payment of debt.
5. In case of hire purchase debts, the auditor should see that instalment yet to be paid by the customers should not be treated as book debts because the customer has a right to return the goods.
6. Debts due by directors or other senior officers of the company jointly of individually should be separately stated. The maximum amount due by directors and senior officers should be stated by way of a foot note in the balance sheet.
7. In case of debts from a subsidiary company under the same management,'he should examine the relevant documents to ascertain the genuineness of the debt and the name of such companies must be disclosed.
8. He should also write to the parties and get balances confirmed by them which will enable him to know the accuracy of the amount receivable.
9. He should ensure that book debts in the balance sheet of a company is shown according to schedule VI of part I of the Companies Act.

12. Bad and Doubtful Debts : The adequacy of the provision for bad and doubtful debts made by the management can be checked by an auditor by considering the following points :

(a) All time barred debts must be treated as bad. So an auditor must check up the period of the debt and see that necessary provision has been made for such bad debts.

(b) He must check the cases of those individual debtors who are not regular in payment of debts according to the terms of agreement and ascertain the collectivility of the debts in each case. Amounts that are definitely not collectible should be written off.

(c) In case of those debtors, who have been adjudicated as insolvent or whose cheques or bills have been dishonoured proper provision must be made.

(d) Provision must also be made for the amounts owing from those debtors against whom suits for realisation of debts are pending in the law courts.

It is not desirable that debts should be written off until there is no further spoke of recovering any thing. Bad debts should not be written off without the function of some official which will prevent the possibility of misappropriations. As regards the amounts of provision to be made in respect of bad and doubtful debts not written off it is suggested that full provision should be made for those debts actually regarded as bad while the doubtful debts should be provided for according to their estimated value depending upon the circumstances of each cash.

Bill Receivable : In order to verify the bills receivable, the auditor should take the following steps:

1. The bills receivable should be compared and counted with the actual bills in hand at the date of balance sheet by examining the bills receivable book.
2. In case the bills have matured and honoured subsequent to the date of the balance sheet but prior to the date of audit, he should vouch the cash received as shown in the cash book or the bank pass book. Similarly, the bills discounted after the date of balance sheet must be vouched with reference to cash collection.
3. He should see that the bills are properly drawn, stamped and duly accepted and they are not overdue. In case of the renewal of any bill, he should examine the new bill with the old bill. Where the part of the original bill has been paid he should vouch the cash received and see that a new bill of the balance amount has been obtained.
4. Where the number of bills is large and they are usually kept with bankers or agents for collection he should obtain a detailed certificate from them and examine the same.
5. In respect of bills discounted or endorsed but remaining outstanding at the time of audit, any contingent liability in respect of such bills should be mentioned as a foot note in the balance sheet.
6. Bills which have been dishonoured before the date of the balance sheet should not be included in the balance sheet as bills receivable in hand as they are no longer assets. The acceptor, dishonouring the bill, should be shown as debtor in the books of accounts.

14. Cash-in-hand : The auditor should carry out cash verification at the end of the year and or by way of a surprise check any time during the year. In the former case, he should visit the clients office on the last day of the closing of the financial period and count the cash-in-hand and compare it with the balance as shown in the cash-book. He should also count the balances of the petty cash book, stamps and I.O.U's in hand. In case there is any shortage, he must report it to the accountant and obtain a certificate to that effect from him. He should insist on the production of all funds in the same location simultaneously. If the cashier has access to funds belonging to other entities like associated companies, staff cluBs", etc., the auditor should seek the cooperation of these entities in ensuring that all funds are checked simultaneously as there is a danger that shortages in one account may be made up from the balance in another account.

Where the whole or a part of the cash is maintained either at an upcountry branch or factory and is not therefore conveniently accessible to the auditor for verification, the client may be advised to deposit the entire amount of cash in hand on the last day in the bank. The auditor should carry out a surprise cash verification whenever he visits such an up country branch or factory during the course of his audit.

15. Cash-at-Bank : The auditor should compare the balance as shown in the pass book with the balance as shown in the bank column of the cash book. In case of difference, bank reconciliation statement should be prepared. In order to avoid the presentation of fictitious pass book, he should also obtain a letter of confirmation from the bankers. Separate certificates should be obtained for fixed deposits, current account and saving bank account, etc., from the bank.

16. Stock-in-Trade : The verification and valuation of the stock-in-trade is one of the most important duties of an auditor in order to arrive at the correct profit and loss of the concern under audit. In various cases, it has been decided that the auditor cannot be asked to take the stock or value it. Practically also, it is impossible for the auditor to physically verify every item of the stock-in-hand because of various reasons i.e. limited time and the lack of technical knowledge etc., still he has to exercise reasonable care in regard to stock verification and valuation. He should make enquiry into the system of internal check, the method of stock taking and the basis of valuation.

The auditor should conduct some tests in order to ascertain the effectiveness of these systems. He should compare the rough stock sheets with fair stock sheets. He should also check the stock books to ascertain the correct position of the stock-in-hand. He should also obtain a certificate from a responsible officer stating that the quantities and the valuation of the various stocks are correct and all the items are the property of the concern. He should also obtain a list duly certified about the obsolete goods which have been discarded.

Method of Stock Taking

The stock verifier goes to the godown and calls out the number and other relevant particulars of the items of each class of goods and another clerk enters these particulars in the stock sheet. Then two clerks of another batch will check the stock-sheet.

The Stock-sheet will then be sent to a responsible officer who fills in the rate of each item of goods at which they are to be valued. The work of calculation is entrusted to a clerk who will calculate the value of each class of goods and his work is then checked by a senior clerk. All those connected with the stock-taking put their initials on the work done by them so that if later on any mistake is found the concerned official may be held responsible for the mistake. All stock-sheet are stand-by the general manager or partner as the case may be.

Care should be taken that goods-in-transit are included. Similarly balances of the unsold stocks at the branches or with the approved agents or 'sent on approval' should be included in the stock-sheet. But goods received by the client on sale or return basis or as a consignee and goods sold but not yet delivered should not be included. The auditor should obtain a certificate with regard to the accuracy of the stock-sheet and its valuation from the senior officer of the concern.

Valuation of Stock-in-Trade

The auditor should consider three principles while valuing the closing stock. One is that stock should be value at cost or market price, whichever is lower at the date of balance sheet. Another principle is that all anticipated losses should be taken into account but anticipated profits should be ignored. Third principle is that the method once adopted should be consistently followed.

The following are the different methods of finding out the cost price of the stock-in-hand :

1. *Unit cost or Actual cost:* Under this method each article, batch and parcel of consignment is valued at its individual cost, but it is not usually capable of application.
2. *Average Cost:* Under this method, the average cost per unit is calculated. The average should be weighted average. The total value of goods (quantity x price) held in stock and those purchased and sold should be divided by the total number of units. This method is adopted when the goods purchased at different times have been mixed up and it is not possible to identify the goods.
3. *First-in First-out (FIFO) :* In this method the whole of the stock is valued at the rate of the latest consignment purchased. This method assumes that the goods issued out of the stores are those which were received first. This method is easy to operate if the prices do not fluctuate very frequently.
4. *Last-in-Flrst-out (LIFO) :* This method is the reverse of FIFO. In this method the whole of the stock is valued at the rate at which the earliest purchases were made. This method assumes that the latest receipts of the materials are issued first and the unsold stock represents the earliest purchases and is priced accordingly.
5. *Base Stock :* Here it is assumed that certain minimum or basis quantity of material should always remain in the store. Therefore the stock should be valued at normal long period price, and not on the basis of dost price or the market price whichever is lower. Excess stock may be valued at cost price or market price whichever is lower.
6. *Standard Cost :* In this method the stock is valued at a predetermined cost per unit, known as standard cost. This method is convenient where goods pass through a number of processes and are manufactured on large scale basis.
7. *Adjusted Setting Price:* In this method the unsold stock is valued at the prevailing price out of which the normal profit plus the estimated cost of disposal i.e., selling expenses and overhead expenses, are deducted.

Market Value

For the calculation of market price there are two methods in use :

1. *Replacement cost method:* It is the cost of replacing an asset at the date of the balance sheet. It means the price at which similar types of goods can be presently purchased from the market.

2. *Net Realisable value method:* Is means the price at which the goods can be sold in the market after deducting the necessary selling expenses.

Whether net realisable value be used or replacement cost method be used, it will depend upon the purpose for which the stock is held. If the purpose is to resale the stock, it may be valued at net realizable value and if it is retained for use then replacement cost method be applied.

Valuation of different items of stock

1. *Raw Materials :* Normally the raw material is purchased for manufacturing goods, hence it should be valued at cost price plus a reasonable proportion of incidental expenses like carriage and freight and excise duty etc. If the raw materials were purchased at different times and the lots could not be identified then average price may be taken. It should be noted that such raw materials should never be used at a higher price than the market price. But a provision for the write off must be made in respect of damaged and obsolete raw materials.

Some materials like wine, timber etc., appreciate in value and hence may be valued at higher price than the cost price. But such value should not be in excess of the market value.

2. *Semi-Finished goods :* In case of semi-finished goods which are in the process of manufacture at the date of balance sheet, they will be valued at the cost price of the raw materials used, plus the proportionate amount of wages and other direct expenses and a percentage of overhead expenses. The auditor should see that the amount in respect of selling and office expenses are not included.

3. *Finished goods :* These goods may be of two types. Firstly, the goods which have been manufactured and are in a deliverable state, will be valued at the manufacturing cost, that is, material, labour and a proportion of factory expenses. If the cost price of the manufactured goods is higher than the market price and they must be valued at market price.

Secondly, in some trading concerns goods are purchased for the purpose of resale. The cost of such goods would be the aggregate of the invoice price (including sales tax, excise duty etc.) and other direct expenses like carriage etc.

4. *Stores :* These are goods which may be in hand at the date of the balance sheet stores are held for use and not for sale in the original form. Examples are Coal, Oil, Fuel etc. They should be valued at cost price. If the market price of such stores have gone down, it has been suggested that they must be written down.

5. *Spare Parts :* Spare parts are used in connection with the maintenance of production facilities. The auditor should get a list of such parts from the works manager. They should be valued at cost price and are not required to be written down to the market value if that value is lower at the date of the balance sheet.

6. Goods on Consignment: It may happen that at the date of the balance sheet, the whole of the consignment or part of it may not have been sold. Such unsold consignment of goods should be valued at cost price, plus proportionate expenses, etc., but it should not be valued at higher price than market price of similar goods. The anticipated losses should be considered while valuing such stock of goods.

The Duty of an Auditor as regards Stock-in-Trade

The duty of an auditor in relation to the stock-in-trade can be understood from the following two points of view:

(i) *Physical Verification of Stock-in-Trade :* This part of auditor's duty is subjected to a great amount of controversy. As a matter of fact an auditor may or may not possess the technical knowledge to verify that the stock-sheets are correct and even if he possesses the necessary knowledge it is not possible for him to inspect each and every item of the stock. The first guiding legal cases in this direction are Kingston Cotton Mills Case and Irish Woollen Co. Ltd. V/s Tyson and others. It was held in these cases it was held that an auditor is not a valuer and it is not his business to take stock and if there are no suspicious circumstances, he is entitled to depend upon the representation of officials. He is not guilty of negligence if he accepts a certificate of such persons as to the value of stock. At the same time it was also stated that he must exercise reasonable care in regard to stock verification and valuation. For instance, he should make enquiry into the system of internal check, the method of stock taking and the basis of valuation compare the rough stock sheets with fair stock sheets etc.

American accountants have not accepted the decision of Kingston Cotton Mills case in view of the decision taken in the case of Mckesson and Robbins. It was decided in this case that the auditor was responsible for the physical verification of the stock in-trade.

In India, the accepted practice of the American Accountants has not been accepted. In India, it is held now that the auditor must present himself when the stock is counted by the company's staff. He should also examine the effectiveness of the system of stock control. He should check the stock sheets and if he does

not do so, he will be held responsible. He should also check the calculations, additions and castings as was held in the case of Henry Squire Ltd.. Vs. Ball Baker and Co. As a result of these decisions, the practice of sending a representative by the auditor at the time of stocktaking is growing in India.

(ii) *Verifying the Valuation of the Stock-in-Trade :* The auditor should apply tests to see that the stock in trade has been appropriately and correctly valued. If he fails in his duty he will be held responsible. Some of the duties of the auditor in this connection are given below:

1. He should satisfy himself that the cost figures have been calculated on some acceptable method and are applied consistently. If the method of valuation has been changed as compared to the previous year, the auditor should mention this fact in his report and if possible, should show the effect of the changed method on the financial position of the concern.

2. He should see that the stock sheets are duly signed by the competent authority and ensure that calculations, additions and castings are correct.

3. He must examine the stock sheets and see that only goods usually dealt in are included. He should also see that fixed assets are not included. Similarly, goods on consignment or sale or return should be included at cost.

4. If the bought and sold books contain quantity columns, the balance shows by them should be compared with the stock sheets.

5. He should see that proper provision is made for the depreciation of the obsolete or defective stock and that trade discounts are deducted.

6. He should compare that stock-sheets with those of the previous year and enquire into major differences.

7. He should compare the prices at which finished goods have been sold and at which the unsold stock has been valued.

8. He should check the percentage of gross profit on sales with that of the last year and find out the causes of any material change.

9. He should see that the stock-in-trade in the balance sheet of a company is shown according to Schedule VI, Part I of the Companies Act.

Verification of Liabilities

Verification of liabilities is equally as important as the verification of assets. If liabilities are not properly verified and valued, the balance sheet will not reveal true and fair view of the state of affairs of a business concern. Therefore, the auditor should examine that:

(a) all the liabilities have been clearly stated on the liability side of the balance sheet;

(b) all these liabilities relate to the business itself;

(c) they are all correct and authorised, and

(d) they are shown in the balance sheet at their actual figures.

The auditor should also obtain a certificate from some responsible official of the business to the effect that all the liabilities for purchases or for expenses have ben recorded in the books of account and all the contingent liabilities have been disclosed by way of footnote in the balance sheet.

The verification and valuation of various liabilities are given as below:

1. *Capital :* In case of a partnership firm the auditor should examine the partnership agreement. He must find out the original capital contributed by each partner and the rate of interest payable on capital. He

must see that capital accounts are correctly maintained and verify all transactions affecting the capital accounts. He should examine the cash book, pass book, withdrawals of the partners and profits and loss earned.

In case of a company while verifying the share capital, the auditor should examine the Memorandum of Association, Articles of Association, Cash Book, Pass Book, and the Minute Books of the Board of directors to find out the number and the different classes of shares issued and the amount received on each type of share. In case of a newly floated company he should undertake an exhaustive checking. If shares have been issued to the vendors or to the promoters for consideration other than cash he should examine the contracts between the vendors or promoters and the company. He should also check the entries regarding the forfeiture of shares, reissue if any, calls in arrears. -

2. Loans : Loans may be of two types :

A. *Unsecured Loans and Advances :* In such a case the auditor should examine the correspondence and relevant documents, if any. He should study the conditions for interest payable, repayment of loan, refund by instalments, etc. He should also ensure that the loans are taken for use in the business. He should also get confirmation from the lenders concerned certifying the balance of principal and interest outstanding at the date of the balance sheet.

B. *Secured Loans and Advances :* In order to verify such loans, the auditor should note (a) Actual amount which has been advanced, and (b) Security for the loan. So far as the actual amount is concerned, the auditor should examine that this amount has been properly authorised and sanctioned by directors in case of a company and by partners in case of a partnership firm. He should examine the applications received and check the receipts which have been given in token of having received the loans. He should also verify that the payment in form of instalment and interest thereon has been received from the borrower himself.

3. *Trade Creditors :* The auditor should take a statement of balances of trade creditors duly signed by a responsible officer and should verify these balances with the bought ledger or the purchase ledger. He may get confirmatory statements from the creditors. He should also examine the invoices as sent by the suppliers and an 'inward Goods Book' if it is maintained.

He should carry out test checking of all the purchases made during the year particularly those made at the end of the year. He should also compare the percentage of the gross profit with that of the previous year. If there are material deviation, he should enquire into the reasons.

For any purchases returns, he should examine the 'Returns Outward Book' and verity them with the help of the credit notes as sent by the supplier.

4. *Outstanding Liabilities for Expenses* : The auditor should obtain a certificate from a responsible officer of the company stating that all outstanding liabilities for goods purchased or for expenses incurred, have been taken into account.

He should verify those items of expenses which usually constitute outstanding liabilities like rent, rate, wages, salary, audit fee, legal expenses etc. He should ascertain the accuracy of the accounting records and test the calculations of such liabilities.

5. Bills Payable: The auditor should obtain a statement of bills payable and compare it with the bills payable book and bills payable account. For bills which have been met after the date of the balance sheet but before the time of audit, he should examine the cash book and bank pass book. He should

ensure that the bills which have been paid are not recorded as outstanding. He should also obtain confirmations in respect of amounts due on the bills accepted by the client that are held by them.

6. Contingent *Liabilities*: Contingent liabilities are those liabilities which may or may not arise in the future for payment, for example, the liability for calls on partly paid shares, liability on bills discounted and the liabilities in respect of arrears of dividend of cumulative preference shares, etc.

Contingent liabilities are divided into two broad categories. One is for those liabilities in respect of which provision has to be made in the balance sheet, for instance, liability which may arise in connection with a suit, etc. Another is for liabilities for which no provision has been made in the books but merely a note has been made at the foot of the balance sheet, for example, bills receivable which have been discounted but not matured at the date of the balance sheet, arrears of fixed accumulated dividends, etc.

The auditor should examine the director's minute book, correspondence made with the legal advisers and the information obtained from the officials of the business. He has to ensure that proper provision has been made for all such liabilities and if he is not satisfied, he should mention the fact in his report.

Lesson 6

COMPANY AUDIT

The companies Act, 1956 requires the compulsory audit of every Joint Stock Company and therefore, an auditor is to be appointed to do the job and submit his report to the shareholders of the Company. After the appointment of the auditor is made, the auditor has to go through some preliminaries before starting the actual work of audit.

The Preliminaries

The Preliminaries are:

1. To see whether his appointment is in order and legal. To ensure it, he should...

(a) where he is appointed as first auditor, get a copy of the resolution by the directors about his appointment;

(b) where he ts appointed in place of retiring auditor, he should enquire from the retiring auditor in writing, whether due notice was given to him and also the circumstances under which he retired, and also if the retiring auditor has any objection to his accepting the appointment. Failure on the part the auditor shall be treated as a breach of professional etiquette.

(c) Where his appointment is made by the shareholders in annual general meeting, he should procure a copy of the shareholders resolution regarding his appointment, and inform the Registrar within 30 days whether he is accepting the appointment.

(d) Where he is appointed in a casual vacancy, by the directors, he should obtain a copy of the director's resolution to this effect.

2. He should obtain a certified list of all the books in use in the Company as also the important documents:

(a) *Memorandum of Association :* he should carefully go through this documents, especially, its Objects Clause and see whether any transaction is not ultra vires the Memorandum. In case there is any, the same be brought to the notice of the shareholders by him. He should also see whether the Issue of Share Capital is within the limits of the Authorised Capital of the Company and according to the Companies Act. Where the Authorised Capital has been increased, he should procure a copy of the resolution. He should carefully examine all the provisions of the Memorandum relating to the accounts of the company.

(b) *Articles of Association :* He should carefully go through the document and satisfy himself regarding —

(i) the issue of share capital and its sub-divisions;

(ii) the payment of underwriting commission and brokerage on shares;

(iii) the amount of minimum subscription, specified in the Articles;

(iv) the call dates and the amount of the calls ;

(v) the rate of interest to be charged on Calls-in-arrears and the rate of interest to be paid on calls-in-advance;

(vi) Rules regarding Forfeiture and re-issue of forfeited shares ;

(vii) Borrowing powers of the company ; and the directors ;

(viii) Rules regarding reorganisation of the share capital;

(ix) Rules regarding appointment, remuneration, powers and duties of the auditor in addition to the statutory powers and duties;

(x) The appointment, remuneration, removal, rights and duties of the directors and various officers of the company ;

(xi) Rules regarding meetings;

(xii) Voting powers of the shareholders;

(xiii) Accounts and audit of the company ;

(xiv) dividends and reserves ;

(xv) Rules regarding the reorganization of the share-capital.

The above are a few important clauses relating to specific matters . Where a company does not have its own Articles of Association, Table A of the Companies Act will apply. The auditor cannot escape his liability on the plea that he did not go through the Articles of the Company or he is unaware of them. (Leeds Estate Building and Investment Society Ltd. v. Shepherd, 1887). The auditor should also carefully note the changes made, if any, in the Articles.

(c) *Prospectus :* Prospectus is an important document. The auditor should examine it to ascertain usually the same points as stated in the Articles. In case of the fist audit of the company, he should peruse it very carefully in order to examine the contracts entered into with the vendors, if there are any such contracts, with the third parties, with the underwriters and brokers. Prospectus also states the information regarding the issue of shares at discount, the amounts payable on application, allotment, calls etc. In the subsequent audits, perusal of Prospectus is not necessary.

(d) *List of Books :* Auditor should ask the company to submit a list of all the books of account, statistical and statutory books maintained by the company. Important books are kept at the Registered Office of the company.

(e) *contracts :* The company might have entered into contracts with the vendors in case of purchase of assets, with the underwriters and brokers and promoters. The auditor should go through all these contracts carefully. Where a statement is given in the Prospectus of the company relating to these contracts, the auditor should see that such statements are correct and the account books have recorded these entries correctly.

(f) *Minute Books :* Minute Books are statutory Books (Section 193). Every Company maintains three types of Minutes Books—

(i) Minute Book of the Shareholders' Meetings ;

(ii) Minute Book of the meetings of the Board of Directors ; and

(iii) Minute Book of the various committees appointed by the Board of Directors.

Minute Books are kept in the form of bound books. The auditor should see that the minutes as recorded in the minute books have been certified by the Chairman of the meeting. The audit of the Minute Books helps the auditor in vouching various transactions e.g., adoption of the annual accounts, calls on shares, directors fees and expenses, appointment of first auditor and his remuneration and authorization of capital expenditure etc.

(g) *Last balance Sheet, Profit & Loss Accounts and Audit Reports* : The auditor should inspect these documents in order to confirm the balance therein are correctly recorded in the new books. Perusal of the last audit report may give some important information useful to the auditor in his work of audit. He should also see whether the recommendations of his predecessor have been

properly carried out. The previous audit reports help the auditor in understanding the working of the company. The minute book of the shareholders will also help him in getting important information regarding the adoption of accounts.

(h) *Certificate of Incorporation and Commencement of Business :* By examining the certificate of Incorporation the auditor can ascertain the date of the formation of the company. He should examine the Certificate to commence business in case of public limited company.

(i) *System of Internal Check :* The auditor should obtain a written statement from a ressponsible officer regarding the system of internal check, internal audit and the system of accountancy adopted by the company.

He should also obtain a list of the officers of the company and the jobs assigned to them. This information shall help him in the quick disposal of queries. In case of any doubt of a transaction, the concerned officer may be contacted for getting the necessary information.

(j) *Audit Report:* Section 227 (2) of the Companies Act, requires a report on the accounts audited by the auditor, to be submitted by him to the Shareholders of the company. The auditor thus has to prepare an audit report on the accounts audited by him and on every balance sheet and profit and loss account and other documents declared by law to be annexed to the balance sheet or the profit and loss account. The report is placed in the Annual General Meeting during the tenure of the auditor. The report is addressed to the shareholders and is sent to the Secretary of the Company. It is duly signed by him. The auditor should sign the report only after being satisfied that the accounts are being approved by the Board and signed by the Directors, before they are submitted to him for his report. (Section 215)

According to Section 227 (2) of the Companies Act, the auditor's report state—

1. Whether, in his opinion and to the best of his information and according to the explanation given to him, the accounts give the information required by the Act and give a rue and fair view of the state of the company' affairs in the case of the balance Sheet as at the end of the financial year and in the case of the Profit & Loss Account for the financial year.

2. Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit.

3. Whether in his opinion. Proper books of account, as required by law have been kept by the company so far as appear from the examination of those books and proper returns adequate for the purpose of his audit have been received from branches not visited by him.

4. Whether the report on the accounts of any branch office audited under section 228, by a person other than the Company's auditor has been forwarded to him as required by clause (e) of sub section (7) of that Section and how he had dealt with the same in preparing auditor's report.

5. Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

The report should also include a statement on such additional matters as specified by the Central Government u/s 227 (4-A) of the Companies Act, i.e., the central Government is empowered to direct by a general order or specified order that in the case as specified companies, the auditors report shall include a statement on such matters as may be specified in its order. With this provision the Central Government now may direct the auditor to examine the specified problems which is in the interest of the members and report thereupon. Thus through the auditor the Government may bring to the information of the shareholders a fact or a point, which it feels necessary and in their best interest.

Lesson 7

Appointment, Powers, Duties And Liabilities of the Auditor

Appointment

Qualifications

In this lesson you are being told about the appointment, powers, duties and liabilities of the auditor. You have already known about the importance of a auditor in a Company, whether a Public Ltd. Company or a Private Ltd. Company. The accounts of the Company are to be audited annually by a qualified auditor. Hence the question is, who is a qualified auditor. The answer to this question can be sought in Section 226 of the Companies Act, which states, "a person shall not be qualified for appointment as auditor of a Company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act 1949". A firm whereof all the partners practising as a Chartered Accountants in India, may also be appointed by its firm's name as an auditor of a company and the partner of the firm may act in the name of the firm.

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

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

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

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

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

Disqualifications

From the above it is clear that the following can not act as an auditor of a Company :

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

(i) a body corporate ;

(ii) an officer or an employee of the company. (Officer here means a director, managing director, manager or secretary);

(iii) a person who is a partner or who is in the employment or an officer or employee of the company;

(iv) a person who owes the company more that Rs. 1,000/- or who has given a guarantee of provided any security in connection with the indebtedness of any third person to the company amounting to more that Rs. 1,000/-.

(v) a person who is disqualified for appointment as an auditor of the company's subsidiary or holding company or a subsidiary of a holding company.

(vi) A person holding any security after a period of one year from the date of commencemence of the companies (Amendment) Act, 2000.

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

Company auditor : Appointment and Removal

(i) a body corporate[1] (because of its characteristic feature of limited liability); or

(ii) an officer or employee of the company under audit; or

(iii) a person who is a partner, or who is in the employment of an officer or employee of the company; or

(iv) a person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee for an amount exceeding one thousand rupees; or

(v) a person holding security, i.e. an instrument which carries voting rights of that company; and

(vi) under section 226 (4), a person who has been disqualified for appointment as an auditor of a company on above-mentioned grounds, shall also not be eligible for appointment with any other body corporate which may be that company's subsidiary or that company's holding company or that company's fellow subsidiary.

Appointment of auditors - Section 224

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

Appointment by directors

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

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

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

Appointment by shareholders

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

*** Subsequent Auditors**

(i) By ordinary resolution

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

(ii) By special resolution

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

In case of certain companies, the auditor is to be appointed only with the approval of the company by a special resolution. Section 224A lays down that in case of a company, in which not less than twenty-five per cent of the subscribed share capital[1] is held, whether singly or in any combination, by :

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

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

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

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

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

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

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

Appointment by the Central Government

(i) If a company, at an annual general meeting, fails to appoint or re-appoint an auditor(s), the Central Government may appoint a person to fill the vacancy under powers conferred upon it by section 224(3). The expression. 'fails to appoint or re-appoint' also includes refusal to accept the appointment by the auditor.

(ii) The said company has to give notice of the above fact to the Government and, if a company fails to give such notice within seven days of the annual general meeting, the company and every officer of the company who is in default shall be punishable with fine, which may extend up to five thousand rupees.

(iii) The appointment by the Central Government is made from the panel of names suggested by the applicant company.

(iv) It may be noted that if appointment of a person as an auditor is void *ab initio,* it should not be treated as a casual vacancy, rather this would give rise to powers of the Central Government under section 224(3).

Appointment by the Comptroller and Auditor General

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

Compulsory re-appointment

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

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

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

(ii) if he has given the company notice in writing about his unwillingness to be re-appointed; or

(iii) if a resolution has been passed at the meeting—

(a) appointing somebody other than him; or

(b) providing expressly that he shall not be re-appointed; or

(iv) if a notice has been given of any resolution proposing the appointment of some other person in place of the retiring auditor (even if such a resolution could not be proceeded with due to death, incapacity or disqualification of that person proposed as auditor); or

(v) if auditor is unable to comply with the ceiling on number of audits under section 224(1B).

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

Ceilling on number of Audits

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

Special Resolution and the appointment of an Auditor

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

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

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

(c) a nationalized bank or an insurance company carrying on general insurance business.

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

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

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

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

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

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

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

2. **Removal after the Expiry of the term**

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

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

Remuneration of an Auditor

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

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

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

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

RIGHTS AND POWERS OF AN AUDITOR

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

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

The auditor has a right to see the books and the vouchers of the Company, at all times, The books here mean the account books as well as the Statutory, statistical and costing books, Vouchers mean documentary evidence of any nature concerning the books and accounts under Audit, He has a right of free and complete access at all times of even the books and vouchers of the Branch. This has been decided in the Cuff vs. London and County Land Building Co. Ltd. (1912) case.

2. *Right to ask for information and clarifications.* (S. 227 (1)),

The auditor has a right to call information and explanations from the directors and officers of the Company. This information and explanation should be necessary for discharging his duties as an auditor while auditing the books of account of the Company.

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

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

4. *Right to make a statement in the meeting.*

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

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

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

6. *Right to visit the Branches.*

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

7. *Right to take legal and technical advice.*

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

8. *Right to ask for remuneration.*

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

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

The auditor has a right to sign the audit report. But where the auditor is a firm, a partner of such firm has a right to sign the audit report, provided he is a practising Chartered Accountant in India. Such partner is also entitled to sign or authenticate any other document of the Company required by law to be signed or authenticated by the auditor.

10. *Right to correction of wrong statements.*

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

DUTIES OF AN AUDITOR

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

A. Duties under the Companies Act

The auditor has the following duties under the Companies Act:

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

(i) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company of its members;

(ii) whether transactions of the company which are represented merely by book entries are not prejudical to the interests of the company;

(iii) where the company is not an investment company within the meaning of Section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company ;

(iv) whether loans and advances made by the company have been shown as deposits ; (v) whether personal expenses have been charged to revenue accounts ;

(vi) whether it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

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

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

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

(a) whether in his opinion and to the best of his information and according to the explanations given to him the accounts give the information required by the Act and in the manner so required.

(b) Whether the balance sheet gives true and fair view of the company's affairs as at the end of the financial year and the profit and loss account gives a true and fair view of the profit and loss of its financial year;

(c) whether he has obtained all the information and explanations required by him for the purposes of his audit;

(d) whether, in his opinion, proper books of account as required bylaw have been kept by the company, and proper returns for the purposes of his audit have been received from the branches not visited by him;

(e) whether the company's balance-sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

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

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

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

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

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

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

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

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

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

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

(a) the number of shares which have been allotted by the company whether for cash or for consideration other than cash;

(b) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(c) an abstract of the receipt of the company and the payments made.

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

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

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

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

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

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

11. *Duty to assist the Advocate General.*

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

B. Duties According to the Legal Decisions

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

1. Duty to inform the members and shareholders about the contravention of the provisions of the company Law.

2. Duty to enrol himself with the Institute of Chartered Accountants of India and to obtain a certificate to practice from it.

3. Duty to acquaint himself with the provisions of the company law and also enquire from his predecessor about it in writing,

4. Duty not to canvass for and also approach and press any member of the company for his appointment as an auditor of the company.

5. Duty to enquire about the true and fair state of affairs of the company and submit his proper report.

6. Duty to verify himself cash in hand and not to be negligent in his work.

7. Duty to see the Debenture Trust Deed and verify whether the debentures issued by the company are according to the terms laid down in the trust Deed.

8. Duty to verify the investments himself.

9. Duty to perform his task with ability, care and skill.

10. Duty to verify the inventories and the ledger accounts.

11. Duty to personally inspect all securities and see that they are in the safe custody of the Secretary of the Company.

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

LIABILITIES OF AN **AUDITOR**

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

A. Civil Liability;

B. Criminal Liability;

C. Liability towards third parties;

D. Liability for libel;

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

(a) Liability for Negligence under the law of Agency;

(b) Liability for Misfeasance under the Statutes—Companies Act and Indian Penal Code.

Let us now discuss these liabilities in some detail.

A. Civil Liability

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

(a) that he was negligent;

(b) that as a result of his negligence the company has suffered the loss ; and

(c) that the loss was suffered by the person to whom the auditor owed a duty. He cannot be relieved of his liability by an agreement entered in between him and his client.

'Negligence' includes the following acts—

(a) Not to see the Articles of Association and not to object payment of dividends out of capital;

(b) Not to get statements of accounts from the creditors and find out the errors and frauds.

(c) Not to verify Cash and Petty Cash;

(d) Not to report to the client about the insufficient provision for bad and doubtful debts, which results in inflating the profits for dividends, thus paying dividends out of capital.

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

B. Criminal Liability

Criminal liability of the auditor arises under the following Acts:

1. Under the Indian Penal Code ;

2. Under the Companies Act;

3. Under the Income-tax Act;

4. Under the Life Insurance Corporation Act;

5. Under the Banking Companies Act;

6. Under the Chartered Accountants Act.

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

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

(a) for authorising the issue of a false prospectus. The penalty for this act is a fine upto Rs. 50.000/- or imprisonment upto a period of 2 years, or both. (S. 63)

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

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

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

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

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

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

(a) Wilfully submitting a false report;

(b) Concealment of frauds in the account books;

(c) Destroying the vouchers and documents concerning account books;

(d) damaging the property of the company;

(e) Abetting in the falsification of the account;

(f) Certifying wilfully the false accounts;

(g) Making a false statement knowingly to be false;

(h) Accepting bribe during the course of discharging his duties as an auditor.

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

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

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

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

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

C. Liabilities Towards Third Parties

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

(a) that the statement was untrue in fact;

(b) that the person making it knew that it was untrue or was recklessly can consciously ignorant whether it was true or not;

(c) that the statement was made with the intention that the third party should act upon it;

(d) that the third party did act on the faith of the statement in the prospectus.

The controversy whether the auditor is liable to the third party is now set at rest and the auditor is now held liable on account of the following reasons—

(a) Certifying the improper accounting procedure due to which embezzlement of an employed of the client could not be detected.

(b) Negligence committed by the employee of the auditor;

(c) Errors committed in the preparation of final accounts,

1) Liability for Libel

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

Liability of an honorary Auditor

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

Liability of a Joint Auditor

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

Liability of Local Auditors

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

SUGGESTED QUESTIONS :

1. Explain the meaning of Auditing. What are the advantages of audit to a company.
2. Discuss the objects of auditing.
3. Comment
   (a) An auditor is a watch dog and not a blood bound.
   (b) Accounting is a necessity, while auditing is a luxury for a business enterprise.
4. Explain clearly the meaning of the term 'continuous Audit. To what type of business is it applicable. State its merits and demerits.
5. Write short notes on :
   (a) Periodical audit.
   (b) Interim audit.
   (c) annual audit.
6. Define Internal control, internal check and internal audit. What are the characteristics of a sound system of Internal check.
7. Write notes on :
   (a) Internal check as regards cash receipts as well as cash payments.
   (b) Internal check as regards sales & purchases.
   (c) Importance of Internal check system.
8. What is audit programme. Discuss its advantages and disadvantages.
9. Vouching is the essence or backbone of auditing. Comment (in light of its objects).
10. How will you vouch :
    (a) Cash sales
    (b) Receipts from debtors
    (c) Cash purchases
    (d) Payment to creditors
    (e) Payment of wages
    (f) Purchase of land and building.
11. Write short notes on verification of :
    (a) creditor

(b) Loans

(c) Contingent liabilities

(d) Plant & machinery

(e) Property

(f) Cash

(g) Stock-in-trade

(h) Share capital

12. What is verification of assets ? What are its objects.
13. Explain the meaning of valuation of assets & difference between valuation and verification.
14. Explain various provisions regarding the appointment of an auditor.
15. What are the qualifications and disqualifications of a company auditor.
16. Write short note on 'removal of an auditor.
17. Discuss the rights and duties of a company auditor.

B.Com. **II Year** **Commerce**

Paper IX-B

Auditing

1. Introduction
2. Internal Check, Internal Audit and Internal control
3. Audit Process
4. Vouching
5. Varification
6. Company Audit
7. Appointment, Powers, Duties and Liabilities of the Auditor

Suggested Questions

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