Study Material

INTEGRATED
PROFESSIONAL
COMPETENCE COURSE

Auditing and Assurance

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

PAPER 6

AUDITING AND ASSURANCE

VOLUME : 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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PREFACE

Auditing is, perhaps, one of the most practical-oriented subjects in the C.A. curriculum. This paper aims to provide working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements. A good knowledge of the subject would provide a strong foundation to students while pursuing the chartered accountancy course. A good understanding of the theoretical concepts, particularly, in the context of auditing standards would make practical training an enriching and enjoying experience. While studying this paper, students are advised to integrate the knowledge acquired in other subjects, specifically, accounting and corporate laws in a meaningful manner. Such a learning would only help a student to become a better professional. In nutshell, it is a subject which involves application of theoretical knowledge of other subjects included in the course curriculum. It is this practical aspect of the subject which allows the individual students to exhibit their intelligence and ability upon which the scoring of the marks depends. A systematic study of the subject will not only help in securing good marks and passing the examination but also enable one to become a good chartered accountant. A list of steps to be followed is given below:

Familiarise yourself with the syllabus: You must know the exact scope of the syllabus. Divide the entire syllabus into broad topics. The broad topics are – 1. Nature and Objectives of Auditing, 2. Audit Planning, Internal Control, Vouching, Verification of assets and liabilities, 3. Company Audit, 4. Special Audits, etc. Such a division of syllabus would always provide a bench-mark to assess the extent of preparation and, thus, infuse confidence.

Read each topic thoroughly: One may read each topic thoroughly, understand and grasp the same. This is not a subject where the student can exploit his intellect and commonsense without having the requisite knowledge of the subject. A thorough preparation is pre-requisite for success in this subject. If necessary, supplement the same with a standard text book. While reading through each topic, take special note of Auditing and Assurance Standards (AASs), Accounting Standards (AS), relevant case laws, provisions of the Companies Act, 1956 or other special legislations, etc. As stated earlier, auditing should not be studied in isolation since it is related to other subjects. In particular, the knowledge of Accounting Standards; laws affecting business organisation, such a Partnership Act, 1932, Companies Act, 1956, etc. is pre-requisite for understanding of the subject and to write a good answer. One must read the monthly publications of the Institute, viz., The Chartered Accountant and the Students' Newsletter regularly to keep abreast of the latest developments in the field.

Prepare Notes: You will appreciate that normally mere reading a page from the book does not lead you anywhere. It is very essential to comprehend the subject. Therefore, effective reading is essential to absorb the same. After reading each chapter, prepare comprehensive notes since the actual writing down of the matter helps not only in understanding but facilitates quick revision as well. You may make use of mnemonic while preparing notes. For example, assertions in respect of an item appearing in the balance sheet to be verified may be remembered as VCREP in the mnemonic form wherein V stands for Valuation, C stands for completeness, R stands for Rights/obligation, E stands for existence and P stands for presentation and disclosure requirements.

Check Your Progress: Perhaps, the best way to check your progress is to go through question papers of previous examinations. An element of introspection is necessary at this stage. In case a student feels that he is not able to answer the requisite number of questions, he must ask himself and ascertain reasons for the same. You must write answers under mock examination conditions to assess your writing capability and compare the same with suggested answers provided by the Board of Studies. Having regard to the extent of changes, students may note that suggested answers to the questions set at the previous Intermediate Examinations would still be beneficial from the academic preparation view point. A word of caution. While going through "Suggested Answers" for previous examinations, no attempt should be made to memorise the answers as such. Rather a student may read them thoroughly to gain knowledge and improve understanding and specifically as to how an answer should be written in the examination.

Examination Approach: Having prepared thoroughly on the aforesaid lines, a student should not rush to write the answers in the examination. Read the question carefully, understand its exact scope, plan the main headings and points to be covered and then write your answer. Answer should be to the point and this can only be so if the question is understood by the students in proper perspective. Question should be read carefully to know its exact requirements. For instance, a question relating to vouching may pertain to any entity or with specific reference to a company. The students should discuss the questions as exhaustively as it could be made remembering at the same time that no insignificant and irrelevant matters are included in the answers. The students should cultivate the habit of remembering all the important and relevant points relating to the question prepared by them. The suggested answers published by the Board stand as the best guide in this rect. Merely stating one or two points is not enough where the question calls for a number of points. All the important and relevant points should either be discussed or at least stated depending upon the marks assigned to the question. Reference to relevant AASs, AS, provisions of the Companies Act, 1956, decided case laws, etc. enriches the quality of an answer. Command over standard

English is absolutely essential. You may divide or sub-divide descriptive questions with distinct paragraph headings. In a professional examination a candidate must attempt all the required number of questions. For instance in Auditing, a candidate must attempt all questions (say, six) in a balanced manner. Proper time management is thus, essential. It may so happen that a candidate is not in a position to write all six answers and may be decided to write five answers in an excellent manner and skip the sixth one. This approach is not advisable since in such a case a candidate would have attempt questions of about 80 marks only. Keep in mind the golden principle that six average answers shall fetch more marks than five best answers.

Read on and Best of Luck !

SYLLABUS

PAPER – 6 : AUDITING AND ASSURANCE

(One Paper- Three hours -100 Marks)

Level of knowledge: Working Knowledge

Objective:

To understand objective and concept of auditing and gain working knowledge of generally accepted auditing procedures and of techniques and skills needed to apply them in audit and attestation engagements.

Contents:

1. Auditing Concepts — Nature and limitations of Auditing, Basic Principles governing an audit, Ethical principles and concept of Auditor's Independence, Relationship of auditing with other disciplines.

2. Auditing and Assurance Standards and Guidance Notes — Overview, Standard-setting process, Role of International Auditing and Assurance Standards Board, Auditing and Assurance Standards issued by the ICAI AAS 1 – AAS 30 and AAS 34; Guidance Note(s) on — Audit of Fixed Assets, Audit of Inventories, Audit of Investments, Audit of Debtors, Loans and Advances, Audit of Cash and Bank Balances, Audit of Miscellaneous Expenditure, Audit of Liabilities, Audit of Revenue, Audit of Expenses.

3. Auditing engagement — Audit planning, Audit programme, Control of quality of audit work — Delegation and supervision of audit work.

4. Documentation — Audit working papers, Audit files: Permanent and current audit files, Ownership and custody of working papers.

5. Audit evidence — Audit procedures for obtaining evidence, Sources of evidence, Reliability of audit evidence, Methods of obtaining audit evidence — Physical verification, Documentation, Direct confirmation, Re-computation, Analytical review techniques, Representation by management, Obtaining certificate.

6. Internal Control — Elements of internal control, Review and documentation, Evaluation of internal control system, Internal control questionnaire, Internal control check list, Tests of control, Application of concept of materiality and audit risk, Concept of internal audit.

7. Internal Control and Computerized Environment, Approaches to Auditing in Computerised Environment.

8. Auditing Sampling — Types of sampling, Test checking, Techniques of test checks.

9. Analytical review procedures.

10. Audit of payments — General considerations, Wages, Capital expenditure, Other payments and expenses, Petty cash payments, Bank payments, Bank reconciliation.

11. Audit of receipts — General considerations, Cash sales, Receipts from debtors, Other Receipts.

12. Audit of Purchases — Vouching cash and credit purchases, Forward purchases, Purchase returns, Allowance received from suppliers.

13. Audit of Sales — Vouching of cash and credit sales, Goods on consignment, Sale on approval basis, Sale under hire-purchase agreement, Returnable containers, Various types of allowances given to customers, Sale returns.

14. Audit of suppliers' ledger and the debtors' ledger — Self-balancing and the sectional balancing system, Total or control accounts, Confirmatory statements from credit customers and suppliers, Provision for bad and doubtful debts, Writing off of bad debts.

15. **Audit of impersonal ledger** — Capital expenditure, deferred revenue expenditure and revenue expenditure, Outstanding expenses and income, Repairs and renewals, Distinction between reserves and provisions, Implications of change in the basis of accounting.

16. Audit of assets and liabilities.

17. Company Audit — Audit of Shares, Qualifications and Disqualifications of Auditors, Appointment of auditors, Removal of auditors, Powers and duties of auditors, Branch audit , Joint audit , Special audit, Reporting requirements under the Companies Act, 1956.

18. Audit Report — Qualifications, Disclaimers, Adverse opinion, Disclosures, Reports and certificates.

19. Special points in audit of different types of undertakings, i.e., Educational institutions, Hotels, Clubs, Hospitals, Hire-purchase and leasing companies (excluding banks, electricity companies, cooperative societies, and insurance companies).

20. Features and basic principles of government audit, Local bodies and not-for-profit organizations, Comptroller and Auditor General and its constitutional role.

Note : Candidates are expected to have working knowledge of relevant Auditing and Assurance Standards issued by the ICAI with reference to above mentioned topics.

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CHAPTER 1

NATURE OF AUDITING

Learning Objectives

After studying this chapter, you will be able to :

- Understand the functional classification and qualities of an auditor.
- Define audit and understand the objectives of audit, basic principles covering audit.
- Distinguish between auditing and investigation.
- Understand different types of audit and relationship of auditing with other disciplines.

1.1 INTRODUCTION

Auditing along with other disciplines such as accounting and law, equips you with all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts, since transactions take place at different points of time with numerous persons and entities. The effect of all transactions have to be recorded and suitably analysed to see the results as regards the business as a whole. Periodical statements of account are drawn up to measure the success or failure of the activities in achieving the objective of the organisation. This would be impossible without a systematic record of transactions. Financial statements are often the basis for decision making by the management and for corrective action so as to even closing down the organisation or a part of it. All this would be possible only if the statements are reliable; decisions based on wrong accounting statements may prove very harmful or even fatal to the business. For example, if the business has really earned a profit but because of wrong accounting, the annual accounts show a loss, the proprietor may take the decision to sell the business at a loss. Thus from the point of view of the management itself, authenticity of financial statements is essential. It is more essential for those who have invested their money in the business but cannot take part in its management, for example, shareholders in a company, such persons certainly need an assurance that the annual statements of accounts sent to them are fully reliable. It is auditing which ensures that the accounting statements are

authentic. In today's economic environment, information and accountability have assumed a larger role than ever before. As a result, the independent audit of an entity's financial statements is a vital service to investors, creditors, and other participants in economic exchange.

Historically, the word 'auditing' has been derived from Latin word "audire" which means "to hear". In fact, such an expression conveyed the manner in which the auditing was conducted during ancient time. However, over a period of time, the manner of conducting has undergone revolutionary change. According to Dicksee, traditionally auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. But this is not the end of matter. In addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined as to whether they portray a true and fair picture.

1.2 NATURE AND PURPOSE OF FINANCIAL STATEMENTS

For correctly realising the role of auditing, you must understand the nature and purpose of the financial statements. 'Financial statements' is a set of documents which show the result of business operation during a period - how the result was achieved and the position of assets and liabilities on the given date. Progress made or success achieved during a certain period can also be readily ascertained from such a set of documents. It also makes an implied representation that it has been properly prepared, shows correct figures and the figures are set against correct description and context.

Regardless of the type of entity - whether in the public or private sector or whether for profit or not - all entities use economic resources to pursue their goals. Financial statements enable an entity's management to provide useful information about its financial position at a particular point of time and the results of its operations and its changes in financial position for a particular period of time. External financial reporting for these entities is directed toward the common interest of various users. Financial statements provide owners with information about the stewardship of management. They also provide a basis for investors' decisions about whether to buy or sell securities; for credit rating services' decisions about the credit worthiness of entities; for bankers' decisions about whether to lend money, and for decisions of other creditors, regulators and others outside the entity.

Information contained in the statement of accounts of a business are primarily intended for the owners. However, many others make use of the information for different purposes.

Management of the business uses it for decision-making purposes, lenders and creditors examine it to establish the degree of safety of their money. Government levies tax putting a *prima facie* reliance on the statements and regulates the socio-economic state of affairs on a summary view of the information contained in various accounting statement made available to it. Investors review the information for making investment decisions and the financial analysts can use the information to assess the performance of an entity. Financial statements are of great significance to workers as well; they want to be assured that reasonable and legitimate share of the revenue earned by the organisation has been paid to them as bonus and the distribution pattern has not violated the norms of social justice.

You will realise, from the above the importance and utility of statements of account and the need for their reliability. To ensure the acceptable degree of reliability and accuracy of the financial statements, examination and appraisal of accounts and the financial picture by an independent expert is necessary. This is what has led to the evolution of the auditing profession.

However, you must be clear on one point. The statements of account are viewed by different interests from different angles; consequently a statement prepared primarily for the use of the owners may not be wholly useful to the other interests. For example, management may need more detailed information on matters considered critical by it, the investors and financial analysts are keen to see the projected image of the present state of affairs. Government would look for inadmissible items under the taxation laws, etc. Separate statements of accounting highlighting the information needed by the interested parties, other than the owners cannot be expected to be prepared in the ordinary course unless the same is specially called for. This makes the preparation of the financial statements more onerous because other users of the statement would use the information subject to such modifications and enquiry as would be considered necessary to meet their respective objective. But they must have an honest assurance that the statements have been properly compiled, prepared and presented to adhere to the requirements of owners. The auditor can accomplish this by a process of examination and appraisal.

Further, it may be noted that the management is responsible for establishing an accounting system to identify, measure, record and adequately disclose an entity's transactions and other events that affect its financial position and results of operations. Management is responsible for selecting accounting principles that appropriately reflect events that occur and for making other accounting estimates and judgments. This responsibility is not lessened by an independent audit.

1.3 AUDITING AND ASSURANCE STANDARDS

1.3.1 International Auditing and Assurance Standards Board

In 1977, the International Federation of Accountants (IFAC) was set up with a view to bringing harmony in the profession of accountancy on an international scale. In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to develop and issue, in the public interest and under its own authority, high quality auditing and assurance standards for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

The IAASB functions as an independent standard-setting body under the auspices of IFAC. The objective of the IAASB is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The IAASB achieves this objective by:

- Establishing high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, banking regulators, securities regulators and other key stakeholders across the world;
- Establishing high quality standards and guidance for other types of assurance services on both financial and non-financial matters;
- Establishing high quality standards and guidance for other related services;
- Establishing high quality standards for quality control covering the scope of services addressed by the IAASB; and
- Publishing other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

The IAASB's Pronouncements: The IAASB's pronouncements govern audit, review, other assurance and related services engagements that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national



standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards. A professional accountant should not represent compliance with the IAASB's Standards unless the professional accountant has complied fully with all of those relevant to the engagement.

1.3.2 Auditing and Assurance Standards Board

The Institute of Chartered Accountants of India is a member of the IFAC and is committed to work towards the implementation of the guidelines issued by the IFAC. The Institute of Chartered Accountants of India constituted the Auditing Practices Committee (APC) in 1982. The main function of the APC is to review the existing auditing practices in India and to develop Statements on Standard Auditing Practices (SAPs) so that these may be issued by the Council of the Institute. While formulating the SAPs in India, the APC gives due consideration to the international auditing guidelines issued by the IAPC and then tries to integrate them to the extent possible in the light of the conditions and practices prevailing in India. While formulating the SAPs, the APC takes into consideration the applicable laws, customs, usages and business environment in India. In July, 2002, the Auditing Practices Committee has been converted into an Auditing and Assurance Standards Board (AASB) by the Council of the Institute, to be in line with the international trend. A significant step has been taken aimed at bringing in the desired transparency in the working of the Auditing and Assurance Standards Board, through participation of representatives of various segments of the society and interest groups, such as, regulators, industry and academics. The nomenclature of SAPs had also been changed to Auditing and Assurance Standards (AASs).

A major development in the field of auditing has been the issuance of revised and /or redrafted International Standards on Auditing pursuant to the Clarity Project of IAASB. The objective of this project is to improve the clarity of International Standards on Auditing (ISAs). The IAASB aims to set high quality international auditing and assurance standards that are understandable, clear and capable of consistent application, thereby serving to enhance the quality and uniformity of practice worldwide. The Auditing and Assurance Standards Board has also laid out a strategy to match step with the IAASB Clarity Project. In the year 2007, the Board issued several revised/new Standards pursuant to the IAASB Clarity Project.

Renaming, Re-numbering and Categorisation of Auditing and Assurance Standards

The Auditing and Assurance Standards Board, in 2007, adopted the *Revised Preface to Standards on Quality Control, Auditing, Review, Other Assurance and Related Services.* In terms of the Revised Preface, the Auditing and Assurance Standards are now renamed based on the type of assurance provided by the engagement undertaken by a member, viz.,

(i) *Standards on Auditing (SAs)* - to be applied in the audit of historical financial information

(ii) *Standards on Review Engagements (SREs)* - to be applied in the review of historical financial information

(iii) *Standards on Assurance Engagements (SAEs)* - to be applied in assurance engagements, engagements dealing with subject matters other than historical financial information

(iv) *Standards on Related Services (SRSs)* - to be applied to engagements to apply agreed upon procedures to information and other related services engagements such as compilation engagements

Further, there is also a mother standard on quality control. In addition, each of the above group of Standards has been allotted a numerical series as follows and the Standards pertaining to a particular group is allotted a number from that numerical series:

Type of Standard	**Numerical Series**
Standards on Quality Control	01-99
Standards on Auditing	100-999
Standards on Review Engagements	2000-2699
Standards on Assurance Engagements	3000-3699
Related Services	4000-4699

The Standards on Auditing have also been further divided into seven categories

based on the aspect of audit engagement addressed by them and each of these categories has a unique numerical series allotted. Therefore, a Standard pertaining to a particular aspect of audit would be al otted a number from that relevant numerical series. These categories and series are as follows:

Aspect of Auditing Covered	Numerical Series
Introductory Matters	100 - 199
General Principles and Responsibilities	200 – 299
Risk Assessment and Response to Assessed	300 - 499
Risk	
Audit Evidence	
Using Work of Others	500 – 599
Audit Conclusions and Reporting	600 - 699
Specialised Areas	700 - 799
	800 - 899

Accordingly, the erstwhile Auditing and Assurance Standard (AAS) 30, *External Confirmations* can be found under the category "Audit Evidence" as Standard on Auditing (SA) 505. Similarly, AAS 3, *Documentation* can be found under the category "General Principles and Responsibilities" as SA 230. The readers would therefore, find the Standards appearing in the order of the new number allotted to them and not the number which they carried as AAS. A complete table of old AAS numbers *vis a vis* corresponding SA number is given below.

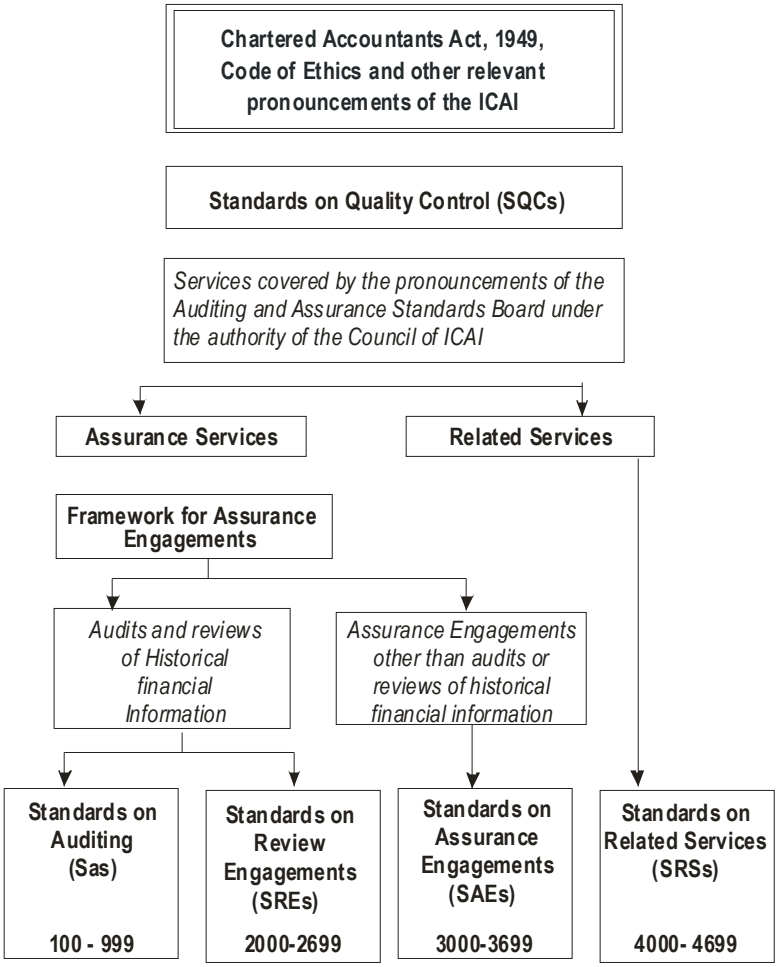
Existing AAS Number	Title of the Standard	New Number of the Standard
1	Basic Principles Governing an Audit	SA 200
2	Objectives and Scope of the Audit of Financial Statements	SA 200A
3	Documentation	SA 230
4	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements	SA 240
5	Audit Evidence	SA 500

6	Risk Assessments and Internal Control	SA 400
7	Relying Upon the Work of an Internal Auditor	SA610
8	Audit Planning	SA 300
9	Using the Work of an Expert	SA 620
10	Using the Work of Another Auditor	SA 600
11	Representations by Management	SA 580
12	Responsibility of Joint Auditors	SA 299
13	Audit Materiality	SA 320
14	Analytical Procedures	SA 520
15	Audit Sampling	SA 530
16	Going Concern	SA 570
17	Quality Control for Audit Work	SA 220
18	Auditing of Accounting Estimates	SA 540
19	Subsequent Events	SA 560
20	Knowledge of the Business	SA 310
21	Consideration of Laws and Regulations in an Audit of Financial Statements	SA 250
22	Initial Engagements – Opening Balances	SA 510
23	Related Parties	SA 550
24	Audit Considerations Relating to Entities Using Service Organisations	SA 402
25	Comparatives	SA 710
26	Terms of Audit Engagement	SA 210
27	Communication of Audit Matters with Those Charged with Governance	SA 260

28	The Auditor's Report on Financial Statements	SA 700
29	Audit in a Computer Information Systems Environment	SA 401
30	External Confirmations	SA 505
31	Engagements to Compile Financial Information	SRS 4410
32	Engagements to Perform Agreed- upon Procedures Regarding Financial Information	SRS 4400
33	Engagements to Review Financial Statements	SRE 2400
34	Audit Evidence - Additional Considerations for Specific Items	SA 501
35	The Examination of Prospective Financial Information	SAE 3400

A diagrammatic representation of the structure of Standards under the new Preface is given below:

Diagrammatic Representation of the Structure of Standards Under the New Preface



The SAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. While discharging their attest function, it will be the duty of members of the Institute to ensure that the SAs are followed in the audit of financial information covered by their audit reports. If for any

reason a member has not been able to perform an audit in accordance with the SAs, his report should draw attention to the material departures therefrom, auditors will be expected to follow SAs in the audits commencing on or after the date specified in the statement. Remember all SAs are mandatory from the date mentioned herein and it is obligatory upon members of Institute to adhere to these whenever an audit is carried out.

All relevant SAs which are important from students' view point have been covered as an integral part of the text.

Procedure for Issuing the Statements on Standard Auditing Practices

Broadly, the following procedure is adopted for the formulation of Auditing and Assurance Standards.

(i) The Auditing and Assurance Standards Board (AASB) determines the broad areas in which the Standard on Auditing (SAs) need to be formulated and the priority in regard to the selection therefor.

(ii) In the preparation of SAs, the AASB is assisted by study groups constituted to consider specific subjects. In the formation of study groups, provision is made for participation of a cross-section of members of the Institute.

(iii) On the basis of the work of the study groups, an exposure draft of the proposed SA is prepared by the Board and issued for comments by members of the Institute.

(iv) After taking into consideration the comments received, the draft of the proposed SA is finalised by the AASB and submitted to the Council of the Institute.

(v) The Council of the Institute will consider the final draft of the proposed SA, and if necessary, modify the same in consultation with the AASB. The SA is issued under the authority of the Council.

Compliance with Documents Issued by the Institute

The Institute has, from time to time, issued 'Guidance Notes' and 'Statements' on a number of matters. The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute:

(a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from the 'Statements', it will be their duty to make **adequate disclosures in their audit reports** so that the users of financial statements may be aware of such deviations; and

(b) to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the **material departures** thereform.

'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so. Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

1.4 DEFINITION OF AUDITING

According to General Guidelines on Internal Auditing issued by the ICAI, "Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report."

The nature of the propositions which an auditor is called upon to review varies. Thus an auditor may review the financial statements of an enterprise to ascertain whether they reflect a true and fair view of its state of affairs and of its working results. In another situation, he may analyse the operations of an enterprise to appraise their cost-effectiveness and in still another, he may seek evidence to review the managerial performances in an enterprise. In yet another type of audit, the auditor may examine whether the transactions of an enterprise have been executed within the framework of certain standards of financial propriety. However, the variations in the propositions do not change the basic philosophy of auditing, though the process of collection and evaluation of evidence and that of formulating a judgment thereon may have to be suitably modified.

According to SA-200 on "Basic Principles Governing an Audit", "An audit is independent examination of financial information of any entity, whether profit oriented or not, and

irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon." The person conducting this process should perform his work with knowledge of the use of the accounting statements discussed above and should take particular care to ensure that nothing contained in the statements will ordinarily mislead anybody. This he can do honestly by satisfying himself that :

(i) the accounts have been drawn up with reference to entries in the books of account;

(ii) the entries in the books of account are adequately supported by underlying papers and documents and by other evidence;

(iii) none of the entries in the books of account has been omitted in the process of compilation and nothing which is not in the books of account has found place in the statements;

(iv) the information conveyed by the statements is clear and unambiguous;

(v) the financial statement amounts are properly classified, described and disclosed in conformity with accounting standards; and

(vi) the statement of accounts taken as an integrated whole, present a true and fair picture of the operational results and of the assets and liabilities.

The aforesaid definition is very authoritative. It makes clear that the basic objective of auditing, *i.e.,* expression of opinion on financial statements does not change with reference to nature, size or form of an entity. The definition given in SA-200 is restrictive since it covers financial information aspect only. However, the scope of auditing is not restricted to financial information only but, today, it extends to variety of non-financial areas as well. That is how various expressions like marketing audit, personnel audit, efficiency audit, production audit, etc. came into existence. Students may note that study material deals with various aspects of financial audit only unless otherwise specified.

1.5 THE AUDITOR

The person conducting audit is known as the auditor; he makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflect a true and fair view. Auditing, especially of companies and for public purposes has become the preserve of persons having recognised professional training and qualification. In India, under the authority of the Companies Act, 1956, only Chartered Accountants, are professionally qualified for the audit of the accounts of companies. Students may note that the provision

relating to restricted state auditors was a transitory provision and has no relevance now. Chartered Accountants are in a position to undertake auditing of almost any accounting aspect, unlike cost accountants whose sphere has been restricted to audit of the cost accounting records and statements. By and large, it is chartered accountants or a firm whose all partners are chartered accountants who act as auditors in India.

1.5.1 Functional Classification of Auditors : Internal Audit vs. External Audit

On the basis of functional division, auditors can be classified in two broad categories, namely, external auditors and internal auditors. External auditors are the persons who practise the profession of accountancy having qualified in the professional examination and are external *vis-a-vis* the organisation of which they audit the accounts. The internal auditors, on the other hand, may also be professionally qualified and are internal *vis-a-vis* the organisation in which they are appointed to perform specific work. They are considered internal because their appointment is done by the management and the scope of work is also specified by it. They may be appointed either on a contract basis or as employees to undertake auditing of the books and records as a part of management control and appraisal system. The external auditors, on the other hand, are appointed by the owners of the organisation, say, shareholders of the company and thus they are treated external to the organisation in which they have been appointed. When an external auditor is appointed under a particular statute, such auditor may be known as the statutory auditor. Their scope of work is determined by the statute under which they have been appointed. Another significant distinction between the internal and external auditor is that the former is not considered independent *vis-a-vis* the management of the organisation while the latter is independent of the management of the organisation which is responsible for the preparation of the books of account. Finally the scope of work of an internal auditor may extend even beyond the financial accounting and may include cost investigation, inquiries relating to losses and wastages, production audit, performance audit, etc. It must be remembered that the basic foundation of any type of auditing, whether internal or external, envisages that the auditor must be independent of the activity for which he is going to conduct an audit. Even though the internal auditor is an employee yet he must be independent to the extent practicable.

1.5.2 Qualities of an Auditor

So far we have discussed the question of formal qualifications of an auditor. But it is not enough to realise what an auditor should be. He is concerned with the reporting on financial matters of business and other institutions. Financial matters, inherently are to be

set with the problems of human fallibility; errors and frauds are frequent. The qualities required, according to Dicksee, are tact, caution, firmness, good temper, integrity, discretion, industry, judgement, patience, clear headedness and reliability. In short, all those personal qualities that go to make a good businessman contribute to the making of a good auditor. In addition, he must have the shine of culture for attaining a great height. He must have the highest degree of integrity backed by adequate independence. In fact, SA-200 mentions integrity, objectivity and independence as one of the basic principles.

He must have a thorough knowledge of the general principles of law which govern matters with which he is likely to be in intimate contact. The Companies Act, 1956 and the Partnership Act, 1932 need special mention but mercantile law, specially the law relating to contracts, is no less important. Needless to say, where undertakings are governed by a special statute, its knowledge will be imperative; in addition, a sound knowledge of the law and practice of taxation is unavoidable.

He must pursue an intensive programme of theoretical education in subjects like financial and management accounting, general management, business and corporate laws, computers and information systems, taxation, economics, etc. Both practical training and theoretical education are equally necessary for the development of professional competence of an auditor for undertaking any kind of audit assignment.

The auditor should be equipped not only with a sufficient knowledge of the way in which business generally is conducted but also with an understanding of the special features peculiar to a particular business whose accounts are under audit. SA-300 on 'Audit Planning' emphasises that an auditor should have adequate knowledge of the client's business. The auditor, who holds a position of trust, must have the basic human qualities apart from the technical requirement of professional training and education.

He is called upon constantly to critically review financial statements and it is obviously useless for him to attempt that task unless his own knowledge is that of an expert. An exhaustive knowledge of accounting in all its branches is the *sine qua non* of the practice of auditing. He must know thoroughly all accounting principles and techniques.

Auditing is a profession calling for wide variety of knowledge to which no one has yet set a limit; the most useful part of the knowledge is probably that which cannot be learnt from books because its acquisition depends on the alertness of the mind in applying to ever varying circumstances, the fruits of his own observation and reflection; only he who is endowed with common sense in adequate measure can achieve it.

Lord Justice Lindley in the course of the judgment in the famous *London & General Bank case* had succinctly summed up the overall view of what an auditor should be as regards the personal qualities. He said, "an auditor must be honest that is, he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true".

1.6 OBJECTIVES OF AUDIT

1.6.1 Expression of opinion

When we speak of the objective, we rationalise the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. In money matters, frauds and errors are common place of occurrence. Apart from this, the statements of account have their own purpose and use of portraying the financial state of affairs. The objective of audit, naturally, should be to see that what the statements of account convey is true and not misleading and that such errors and frauds do not exist as to distort what the accounts really should convey.

Till recently, the principal emphasis was on arithmetical accuracy; adequate attention was not paid to appropriate application of accounting principles and disclosure, for ensuring preparation of accounting statements in such a way as to enable the reader of the accounting statement to form a correct view of the state of affairs. Quite a few managements took advantage of the situation and manipulated profit or loss and assets and liabilities to highlight or conceal affairs according to their own design. This state of affairs came up for consideration in the *Royal Mail Steam Packet Company's Case* as a result of which the Companies Acts of England and India were amended in 1948 and 1956 respectively to require the auditor to state *inter alia* whether the statements of account are true and fair. This is what we can take as the present day audit objective. The implication of the substitution of "true and correct" by "true and fair" need to be understood. There has been a shift of emphasis from arithmetical accuracy to the question of reliability to the financial statements. Mind you, a statement may be reliable even though there are some errors or even frauds, provided they are not so big as to vitiate the picture. The word "correct" was somewhat misplaced as the accounting largely consists of estimates.

However, you should not infer that the detection of errors and frauds is no longer an audit objective: it is indeed an audit objective because statements of account drawn up from books containing serious mistakes and fraudulent entries cannot be considered as a true and fair statement. To establish whether the financial statements show a true and fair

state of affairs, the auditors must carry out a process of examination and verification and, if errors and frauds exist they would come to his notice in the ordinary course of checking. But detection of errors and frauds is not the primary aim of audit; the primary aim is the establishment of a degree of reliability of the annual statements of account.

If there remains a deep laid fraud in the accounts, which in the normal course of examination of accounts may not come to light, it will not be construed as failure of audit, provided the auditor was not negligent in the carrying out his normal work. This principle was established as early as in 1896 in the leading case in *Re-Kingston Cotton Mills Co.*

The nature of audit objectives was also highlighted in the leading case *Re The London and General Bank Ltd. [1895].* It was held that an auditor must ascertain that the books of account show the true financial position of the company. For the first time, the duties of the company auditor were spelled out in specific terms. Lord Justice Lindley observed, "It is no part of an auditor's duty to give advice either to directors or shareholders as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans without security. It is nothing to him whether the business of company is being conducted prudently or unprudently, profitably or unprofitably; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit and his duty is confined to that."

The SA-200A "Objective and Scope of the Audit of Financial Statements" states that the objective of an audit of financial statements, prepared within a framework of recognised accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. Further it clarifies that "the auditor's opinion helps determination of the true and fair view of the financial position and operating results of the enterprise. The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of an enterprise or the efficiency or effectiveness with which the management has conducted the affairs of the enterprise". So it follows from above that it is no part of the auditor's duty to probe into the propriety of business conduct. This contention has been held perfectly valid as it has been asserted that the conventional financial audit is concerned with examination of the transactions to ascertain the true and fair nature of the financial statements. The auditor is merely concerned with evaluating the evidence in support of transactions but need not examine the regularity and prudence of various decisions taken by the management.

However, of late, this has undergone a change as some of the requirements of law introduced in the past require the company auditor to go beyond the functions of reporting

and express an opinion about the propriety or prudence of certain transactions in certain specific areas. Sub-sections (1A) and (4A) of the section 227 of the Companies Act, 1956 contain various such matters. It may also be clarified that the usage of words "true and fair" is restricted to certain countries such as U.K. while in other countries like United States the expression "full and fair" is prevalent. However both expressions aim to convey same meaning.

On a consideration of what has been discussed, it may be summed up that auditing has the principal objective of seeing whether or not the financial statement portray a true and fair state of affair and of reporting accordingly. An incidental and secondary, but by no means an insignificant audit objective, flowing from the former, is detection of errors and frauds and making recommendations to prevent their occurrence.

1.6.2 Errors and Frauds

Accounting is a device for collecting and presenting useful information in financial terms about a business enterprise. It should as well be recognised that accounting data may contain errors for a variety of reasons, and those who rely on accounting data frequently have no way of determining for themselves the reliability of data presented. Even today the human element is the most significant element for recording and processing the accounting data. Human beings as they are, are always open to personal failures and allurement. The audit objective, in the past was, primarily concerned with the detection of errors and frauds and now, though the general audit engagement do not specifically require their detection, they do not rule them out and in fact stipulate their detection on the premise that no statements of account can be considered true and fair if substantial errors and frauds remain to distort the picture. Another presumption about errors and frauds which has wide recognition, is that the audit techniques and processes, if carried on conscientiously would bring to light errors and frauds even though the examination was not specifically directed to reveal them.

In the context of auditor's role in detection of frauds, a significant development in the sphere of management is the installation of control devices by the management to ensure compilation of reliable statements of account. These are designed to plug the possibilities of errors and frauds as they provide means for their early detection. It is true that management is responsible for prevention of errors and frauds. It can be argued that the auditor's role in their detection is very much conditioned by these developments. The auditor can achieve a lot by a purposeful review of those control systems and their operation. While conducting audit, the auditor may come to know the area where control is not fool proof or where control measures have not been properly operated with a view to

ensuring better control over errors and frauds. In such instances, the auditor may provide the management with practicable suggestions for alteration or modification of the controls and checks. This is a safety for the future. It is a matter of safety for the business because by acting on the expert suggestions, a better assurance for obtaining reliable accounts is there. It is a safety for the auditor, if in future he is hauled up before the Court to defend a charge of negligence for non-detection of errors and frauds; it would be to his defence that he had already made the management aware of the weaknesses in the book-keeping system and procedures and the management had failed to act on his suggestions [*Re S. P. Catterson & Sons Ltd.]*.

If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests :

(a) whether the auditor has exercised reasonable care and skill in carrying out his work;

(b) whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;

(c) whether the auditor had any reason to suspect the existence of the errors and frauds; and

(d) whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

We have so far discussed the general background and the position of the auditors as regards errors and frauds and we know that the auditor has a certain amount of responsibility for their detection.

We shall now analyse the causes and nature of errors and frauds. If an auditor is aware of these, detection becomes easier in the sense that he can direct his enquiry more objectively and plan his work having regard to general possibility of errors and frauds.

R.K. Mautz, in his book on "Fundamentals of Auditing" has classified the reasons and circumstances of errors and he has included fraud in the broad category of errors. The classifications are the following :

1. Ignorance on the part of employees of accounting developments, generally accepted accounting principles, appropriate account classification of the necessary reconciling subsidiary ledgers with controlling accounts and of good accounting practices in general.

2. Carelessness on the part of those doing the accounting work.

3. A desire to conceal the effect of defalcations of shortages of one kind or another.
4. A tendency of the management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever present desire to hold taxes on income to minimum.

A sixth cause may be added to those Mr. Mautz has listed and that is more serious in nature. It is the intentional effort committed by persons in position of authority to :

(i) show up the picture depicted by the statements;

(ii) depress the picture depicted by the statements; and

(iii) convert the error to a personal benefit.

Errors and frauds both distort the true picture either by omission or by commission but the distinction between the two lies in intent. Error is an involuntary act whereas fraud is a deliberate act. Mautz also has classified the types of errors. These are :

1. Self-revealing and not self-revealing
2. Unintentional and intentional
3. Unconcealed and concealed
4. Affecting general ledger balances and not affecting general ledger balances.

Self-revealing errors: These are such errors the existence of which becomes apparent in the process of compilation of accounts. A few illustrations of such errors are given hereunder, showing how they become apparent.

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(ii)	Wrong totalling of the Purchase Register.	Control Account (*e.g.*, the Sundry Creditors Account) balances and the aggregate of the balances in the personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

Many other errors, however, are not revealed by either of these possibilities. If an item of expense which should have been charged to repairs account has been charged by mistake to the building account or if the amount of depreciation is calculated incorrectly, there is nothing in the book-keeping system which will bring the error to notice. Such errors are non self-revealing errors.

Suppose a debit entry is omitted to be posted in the ledger and there are one or more of such omissions of credit entries which exactly compensate the effect of the former omission, then another self-revealing error turns to be not so. Such mistakes may remain undetected indefinitely unless measures aimed at discovering such errors are applied.

Intentional Errors or Frauds: Fraud is the word used to mean intentional error. This is done deliberately which implies that there is an intent to deceive, to mislead or at least to conceal the truth. It follows that other things being equal, they are more serious than unintentional errors because of the implication of dishonesty which accompanies them.

As per SA-240, "Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatements:

(i) ***Fraudulent Financial Reporting:*** It involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared. For example, in a period of rising prices, sales contract documents may be ante-dated to record sales at prices lower than the prices at which sales have actually taken place.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information. For example, goods sold may not be recorded as sales but included in inventories.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure. For example, where a contracting firm follows the 'completed contract' method of accounting but does not provide for a known loss on incomplete contracts.

(ii) ***Misappropriation of Assets***: It involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

Therefore, it is clear from the above that the 'fraud' deals with intentional misrepresentation but, 'error', on the other hand, refers to unintentional mistakes in financial information.

Intentional errors are most difficult to detect and auditors generally devote greater attention to this type because out of long and sometimes unfortunate experience, auditors have developed a point of view that if they direct their procedures of discovering the more difficult intentional errors, they are reasonably certain to locate the more simple and far more common unintentional errors on the way. The auditors have also learnt by experience that although most people are honest under different circumstances but they may be unable to resist temptations. When circumstances are such that the possibility of being caught is rather remote, most people are likely to respond to temptation. This is a well known aspect of human behaviour. Auditors while studying the possibility and nature of fraud, must keep this always in mind and should not make any exception for those who held high offices. Factors, like job satisfaction in terms of responsibility, trust and reward, personal habits, temporary requirements etc., have great bearing on the matter of commission of fraud. These things generally start in a non-consequential way-often a subordinate staff member first borrows small amounts from the cash box to meet his temporary difficulty and then gradually it becomes his habit to borrow in such manner whenever he is in difficulty; when he finds that nobody has even an inkling of the matter, he ventures with far larger amounts which on many occasions, he finds himself unable to replace. Fraud also takes place in forms other than cash defalcation, discussed above. It may be misappropriation of goods or manipulation of accounts with a view to presenting a false state of affairs.

Defalcation of Cash: Defalcation of cash has been found to perpetrated generally in the following ways:

(a) By inflating cash payments.

Examples of inflation of payments:

(1) Making payments against fictitious vouchers.

(2) Making payments against vouchers, the amounts whereof have been inflated.

(3) Manipulating totals of wage rolls either by including therein names of dummy workers or by inflating them in any other manner.

(4) Casting a larger totals for petty cash expenditure and adjusting the excess in the totals of the detailed columns so that cross totals show agreement.

(b) By suppressing cash receipts. Few Techniques of how receipts are suppressed are:

(1) *Teeming and Lading* : Amount received from a customer being misappropriated; also to prevent its detection the money received from another customer subsequently being credited to the account of the customer who has paid earlier. Similarly, moneys received from the customer who has paid thereafter being credited to the account of the second customer and such a practice is continued so that no one account is outstanding for payment for any length of time, which may lead the management to either send out a statement of account to him or communicate with him.

(2) Adjusting unauthorised or fictitious, rebates, allowances, discounts, etc. customer' accounts and misappropriating amount paid by them.

(3) Writing off as debts in respect of such balances against which cash has already been received but has been misappropriated.

(4) Not accounting for cash sales fully.

(5) Not accounting for miscellaneous receipts, *e.g.,* sale of scrap, quarters allotted to the employees, etc.

(6) Writing down asset values in entirety, selling them subsequently and misappropriating the proceeds.

(c) By casting wrong totals in the cash book.

Misappropriation of Goods: Fraud in the form of *misappropriation of goods* is still more difficult to detect; for this management has to rely on various measures. Apart from the various requirements of record keeping about the physical quantities and their periodic checks, there must be rules and procedures for allowing persons inside the area where goods are kept. In addition there should be external security arrangements to see that no goods are taken out without proper authority. Goods can be anything in the premises; it may be machinery. It may even be the daily necessities of the office like stationary. The goods may be removed by subordinate employees or even by persons quite higher up in the management. Auditors can detect this by undertaking a thorough and strenuous checking of records followed by physical verification process. Also, by resorting to intelligent ratio analysis, auditors may be able to form an idea whether such fraud exists. For example, the gross profit ratio adjusted for any recorded change during the year,

reveals whether the value of stock is reasonable with reference to the amount of the sale. Similarly, the input-output ratio of production in terms of physical quantity may reveal whether output is normal with reference to the quantity consumed for production.

Manipulation of Accounts: Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way. This type of fraud is generally committed :

(a) to avoid incidence of income-tax or other taxes;

(b) for declaring a dividend when there are insufficient profits;

(c) to withhold declaration of dividend even when there is adequate profit (this is often done to manipulate the value of shares in stock market to make it possible for selected persons to acquire shares at a lower cost); and

(d) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

There are numerous ways of committing this type of fraud. Some of the methods are given below:

(i) inflating or suppressing purchases and expenses;

(ii) inflating or suppressing sales and other items of income,

(iii) inflating or deflating the value of closing stock;

(iv) failing to adjust outstanding liabilities or prepaid expenses; and

(v) charging items of capital expenditure to revenue or by capitalising revenue expenses.

Concealed and Unconcealed Errors: As a general rule, mistakes are unconcealed but frauds are deliberately concealed. This proposition does not need any elaboration; but exceptions are in both cases. Mistakes become concealed if compensated by another or more mistakes in the opposite direction; or it may even be greatly minimised by that chance happening. For example, by mistake one or more accounts were short debited by an aggregate figure of Rs. 30,000 and this short debit is compensated by chance error or say short casting or one or more credit accounts to the tune of say Rs. 30,200 the dimension of the error would apparently be Rs. 200 by which the trial balance would be thrown out of agreement and there may be a temptation to think, “the error is small, let us ignore it”. This attitude towards apparently small errors is dangerous because its true dimensions remain concealed and that may render the statements of account totally

unacceptable. Mistakes may as well be concealed for wrong arithmetical calculations or for a faulty process of verification. Depreciation and stocks are examples which immediately come to one's mind. Wrong calculation of depreciation or omission to include certain stocks in the inventory or wrong valuation of stocks are not apparent. Petty cash defalcation is often unconcealed because petty cash is an item which on many occasions is left out of checking.

Procedural Errors: Sometimes we become so obsessed with the general ledger and its supporting records that we neglect other important features of the accounting system. An accounting system includes both records and procedure. Errors can appear in either or both. Whatever errors occur in the implementation of the procedures may be termed as procedural errors (which include frauds also). For example, the sales procedure of a company may include the following steps:

(a) Receipt of an order through salesman.

(b) Review of order by the credit department to determine whether the customer should be given credit as requested.

(c) Clearance with inventory department to be sure that the order can be executed.

(d) Preparation of forwarding note with copies to obtain the customer's acknowledgement of the receipt of goods.

(e) Preparation of invoice and despatch of the same to the customer.

If the procedure requires that these steps should be taken in the order indicated and if, for any reason, the second step is omitted, or is not completed before subsequent steps have been taken an error in procedure has been made and this may lead the company into financial loss caused by non-recovery of the money. Procedures are established to maintain control over resources and over transactions; any failure to follow the established procedures lessens the control and may permit errors which do affect ledger accounts. Any breakdown in established procedures thus suggests not only the presence of a procedure type error but also of other consequences.

Other errors of this type include the approving of transactions of documents by some one other than the person authorised to do so, failure to ensure that all preceding steps have been taken before approving a document and substitution of one person by another in a procedural function without proper authority. It is the normal procedure that goods, when received should be inspected for quality by the inspection department staff. If the store-keeper carried out this function it is indeed risky. Similarly, if the procedure requires that the timber godown should have been given periodical insecticide treatment and

management has ignored that, a great loss may be caused to the timber by white ants. What is needed to be emphasised here is this that a procedural error, which is neither a defalcation nor misappropriation, may involve the company in a sizeable loss. This type of error or fraud cannot be located by any rigorous examination of the books of account.

All these errors discussed above may be grouped in the following categories in terms of their accounting incidence :

(i) Errors of omission - where a transaction has been omitted either wholly or partially.

(ii) Errors of commission - where a transaction has been misrecorded either wholly or partially.

(iii) Compensating errors - where there are two or more errors which exactly counter balance each other, so that the trial balance agrees in spite of them.

(iv) Errors of principle - these are errors arising as a result of transactions having been recorded in a fundamentally incorrect manner; for example, a distinction not being made between capital and revenue income or expenditure.

(v) Procedural errors.

1.6.3 Detection of Fraud and Error : Duty of an Auditor

SA-240, "Auditors Responsibility to Consider Fraud and Error in an Audit of Financial Statements", deals at length with the auditor's responsibilities for the detection of material misstatements resulting from fraud and error when carrying out an audit of financial information and to provide guidance as to the procedures that the auditor should perform when he encounters circumstances that cause him to suspect, or when he determines, that fraud or error has occurred. Broadly, the general principles laid down in the SA may be noted as under:

(i) In planning and performing his examination, the auditor should take into consideration the risk of material misstatement of the financial information caused by fraud or error. He should inquire of management as to any fraud or significant error which has occurred in the reporting period and modify his audit procedures, if necessary.

(ii) If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate.

(iii) The auditor should satisfy himself that the effect of fraud is properly reflected in the financial information or the error is corrected in case the modified procedures performed by the auditor confirm the existence of the fraud. In case auditor is unable to obtain evidence to confirm or dispel a suspicion of fraud, the auditor should consider relevant laws and regulations and may wish to obtain legal advice before rendering any report on the financial information or before withdrawing from the engagement.

(iv) The reporting responsibilities would also include communicating with management. When those persons ultimately responsible for the overall direction of the entity are doubted, the auditor may seek legal advice to assist him in the determination of procedures to follow. The auditor should also consider the implications of the circumstances on the true and fair view which the financial statements ought to convey and frame his report appropriately. Where a significant fraud has occurred the auditor should consider the necessity for a disclosure of the fraud in the financial statements and if adequate disclosure is not made, the necessity for a suitable disclosure in his report.

SA-240, "Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements", by way of example lists certain risk factors and circumstances relating to possibility of fraud which may be considered by the auditor are dealt in the following paragraphs.

Examples of Risk Factors Relating to Misstatements Resulting from Fraud: The fraud risk factors identified below are examples of such factors typically faced by auditors in a broad range of situations. However, the fraud risk factors listed below are only examples; not all of these factors are likely to be present in all audits, nor is the list necessarily complete. Furthermore, the auditor exercises professional judgment when considering fraud risk factors individually or in combination and whether there are specific controls that mitigate the risk.

I. Fraud Risk Factors Relating to Misstatements Resulting from Fraudulent Financial Reporting:

Fraud risk factors that relate to misstatements resulting from fraudulent financial reporting may be grouped in the following three categories:

1. *Management's Characteristics and Influence over the Control Environment.*
2. *Industry Conditions.*
3. *Operating Characteristics and Financial Stability.*

For each of these three categories, examples of fraud risk factors relating to misstatements arising from fraudulent financial reporting are set out below:

1. *Fraud Risk Factors Relating to Management's Characteristics and Influence over the Control Environment:*

A. These fraud risk factors pertain to management's abilities, pressures, style, and attitude relating to internal control and the financial reporting process.

- ♦ There is motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:
- ♦ A significant portion of management's compensation is represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow.
  - ✓ There is excessive interest by management in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
  - ✓ Management commits to analysts, creditors and other third parties to achieving what appear to be unduly aggressive or clearly unrealistic forecasts.
  - ✓ Management has an interest in pursuing inappropriate means to minimize reported earnings for tax-motivated reasons.

B. There is a failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:

- ♦ Management does not effectively communicate and support the entity's values or ethics, or management communicates inappropriate values or ethics.
- ♦ Management is dominated by a single person or a small group without compensating controls such as effective oversight by those charged with governance.
- ♦ Management does not monitor significant controls adequately.
- ♦ Management fails to correct known material weaknesses in internal control on a timely basis.
- ♦ Management sets unduly aggressive financial targets and expectations for operating personnel.
- ♦ Management displays a significant disregard for regulatory authorities.

- Management continues to employ ineffective accounting, information technology or internal auditing staff.
- Non-financial management participates excessively in, or is preoccupied with, the selection of accounting principles or the determination of significant estimates.
- There is a high turnover of management, counsel or board members.
- There is a strained relationship between management and the current or predecessor auditor. Specific indicators might include the following:
  - ✓ Frequent disputes with the current or a predecessor auditor on accounting, auditing or reporting matters.
  - ✓ Unreasonable demands on the auditor, including unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
  - ✓ Formal or informal restrictions on the auditor that inappropriately limit the auditor's access to people or information, or limit the auditor's ability to communicate effectively with those charged with governance.
  - ✓ Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work.
- There is a history of securities law violations, or claims against the entity or its management alleging fraud or violations of securities laws.
- The corporate governance structure is weak or ineffective, which may be evidenced by, for example:
  - ✓ A lack of members who are independent of management.
  - ✓ Little attention being paid to financial reporting matters and to the accounting and internal control systems by those charged with governance.

2. *Fraud Risk Factors Relating to Industry Conditions*: These fraud risk factors involve the economic and regulatory environment in which the entity operates.
   - New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity.
   - A high degree of competition or market saturation, accompanied by declining margins.
   - A declining industry with increasing business failures and significant declines in customer demand.

- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.

3. *Fraud Risk Factors Relating to Operating Characteristics and Financial Stability:* These fraud risk factors pertain to the nature and complexity of the entity and its transactions, the entity's financial condition, and its profitability.

- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity (including a need for funds to finance major research and development or capital expenditures).
- Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity (for example, the ultimate collectibility of receivables, the timing of revenue recognition, the realisability of financial instruments based on highly-subjective valuation of collateral or difficult-to-assess repayment sources, or a significant deferral of costs).
- Significant related party transactions which are not in the ordinary course of business.
- Significant related party transactions which are not audited or are audited by another firm.
- Significant, unusual or highly complex transactions (especially those close to year-end) that pose difficult questions concerning substance over form.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- An overly complex organizational structure involving numerous or unusual legal entities, managerial lines of authority or contractual arrangements without apparent business purpose.
- Difficulty in determining the organization or person (or persons) controlling the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.

- Unusually high dependence on debt, a marginal ability to meet debt repayment requirements, or debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- A threat of imminent bankruptcy, foreclosure or hostile takeover.
- Adverse consequences on significant pending transactions (such as a business combination or contract award) if poor financial results are reported.
- A poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

Fraud Risk Factors Relating to Misstatements Resulting from Misappropriation of Assets: Fraud risk factors that relate to misstatements resulting from misappropriation of assets may be grouped in the following two categories:

1. Susceptibility of Assets to Misappropriation.
2. Controls.

For each of these two categories, examples of fraud risk factors relating to misstatements resulting from misappropriation of assets are set out below. The extent of the auditor's consideration of the fraud risk factors in category 2 is influenced by the degree to which fraud risk factors in category 1 are present.

1. *Fraud Risk Factors Relating to Susceptibility of Assets to Misappropriation*: These fraud risk factors pertain to the nature of an entity's assets and the degree to which they are subject to theft.
   - Large amounts of cash on hand or processed.
   - Inventory characteristics, such as small size combined with high value and high demand.
   - Easily convertible assets, such as bearer bonds, diamonds or computer chips.
   - Fixed asset characteristics, such as small size combined with marketability and lack of ownership identification.
2. *Fraud Risk Factors Relating to Controls*: These fraud risk factors involve the lack of controls designed to prevent or detect misappropriation of assets.
   - Lack of appropriate management oversight (for example, inadequate supervision or inadequate monitoring of remote locations).
   - Lack of procedures to screen job applicants for positions where employees have access to assets susceptible to misappropriation.

- Inadequate record keeping for assets susceptible to misappropriation.
- Lack of an appropriate segregation of duties or independent checks.
- Lack of an appropriate system of authorization and approval of transactions (for example, in purchasing).
- Poor physical safeguards over cash, investments, inventory or fixed assets.
- Lack of timely and appropriate documentation for transactions (for example, credits for merchandise returns).
- Lack of mandatory vacations for employees performing key control functions.

II. Examples of Circumstances that Indicate the Possibility of Fraud or Error

The auditor may encounter circumstances that, individually or in combination, indicate the possibility that the financial statements may contain a material misstatement resulting from fraud or error. The circumstances listed below are only examples; neither all of these circumstances are likely to be present in all audits nor is the list necessarily complete. Circumstances that indicate a possible misstatement are discussed in paragraphs 43-44.

- Unrealistic time deadlines for audit completion imposed by management.
- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators and bankers.
- Limitation in audit scope imposed by management.
- Identification of important matters not previously disclosed by management.
- Significant difficult-to-audit figures in the accounts.
- Aggressive application of accounting principles.
- Conflicting or unsatisfactory evidence provided by management or employees.
- Unusual documentary evidence such as handwritten alterations to documentation, or handwritten documentation which is ordinarily electronically printed.
- Information provided unwillingly or after unreasonable delay.
- Seriously incomplete or inadequate accounting records.
- Unsupported transactions.
- Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year-end.



- Transactions not recorded in accordance with management's general or specific authorization.
- Significant unreconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.
- Inadequate control over computer processing (for example, too many processing errors; delays in processing results and reports).
- Significant differences from expectations disclosed by analytical procedures.
- Fewer confirmation responses than expected or significant differences revealed by confirmation responses.
- Evidence of an unduly lavish lifestyle by officers or employees.
- Unreconciled suspense accounts.
- Long outstanding account receivable balances.

1.7 ASPECTS TO BE COVERED IN AUDIT

The principal aspect to be covered in an audit concerning final statements of account are the following :

(i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.

(ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

(iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.

(iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.

(v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.

(vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.

(vii) Verification of the title, existence and value of the assets appearing in the balance sheet.

(viii) Verification of the liabilities stated in the balance sheet.

(ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.

(x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.

(xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organisation.

It will thus be realised that the duties are not limited to the verification of the arithmetical accuracy of the books of account kept by his client; he must also satisfy himself that entries in the books are true and contain a complete record of all the transactions of the business and these are recorded in such a manner that their real nature is revealed. On that account, he must examine all vouchers, invoices, minutes of directors or partners correspondence and other documentary evidence that is available to establish the nature and authenticity of the transactions. Besides, he must verify that there exists a proper authority in respect of each transaction; that each transaction is correctly recorded, etc. Finally, he must verify that the form in which the final accounts are drawn up is the one prescribed by law or is the one that ordinarily would present a true and fair picture of state of affairs of the business.

1.8 BASIC PRINCIPLES GOVERNING AN AUDIT

SA-200 describes the basic principles which govern the auditor's professional responsibilities and which should be complied with whenever an audit is carried out. Compliance with the basic principles requires the application of auditing procedures and reporting practices appropriate to the particular circumstances. The basic principles as stated in this guideline are:

1. *Integrity, objectivity and independence* : The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

2. *Confidentiality* : The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

3. *Skills and competence* : The audit should be performed and the report prepared with due professional care by persons who have adequate training, experience and competence in auditing. The auditor requires specialised skills and competence which are acquired through a combination of general education, knowledge obtained through study and formal courses concluded by qualifying examination recognised for this purpose and practical experience under proper supervision. In addition, the auditor requires a continuing awareness of developments including pronouncements of the ICAI on accounting and auditing matters, and relevant regulations and statutory requirements.

4. *Work performed by others* : When the auditor delegates work to assistants or uses work performed by other auditors and experts he continues to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. In the case of any independent statutory appointment to perform the work on which the auditor has to rely in forming his opinion, as in the case of the work of branch auditors appointed under the Companies Act, 1956 the auditor's report should expressly state the fact of such reliance. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditor or experts is adequate for his purpose.

5. *Documentation* : The auditor should document matter which are important in providing evidence that the audit was carried out in accordance with the basic principles.

6. *Planning* : The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business. Plans should be made to cover, among other things :

   (a) acquiring knowledge of the client's accounting system, policies and internal control procedures;

   (b) establishing the expected degree of reliance to be placed on internal control;

   (c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

   (d) co-ordinating the work to be performed.

   Plans should be further developed and revised as necessary during the course of the audit.

7. *Audit Evidence* : The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information. *Compliance procedures* are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. *Substantive procedures* are designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.

   They are of two types :

   (i) test of details of transactions and balances; and

   (ii) analysis of significant ratios and trends including the resulting enquiry of unusual fluctuations and items.

8. *Accounting System and Internal Control* : Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. The auditor should reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal controls normally contribute to such assurance.

   The auditor should gain an understanding of the accounting system and related controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive than would otherwise be required and may also differ as to their nature and timing.

9. *Audit conclusions and reporting* : The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information. This review and assessment involves forming an overall conclusion as to whether :

   (a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

   (b) the financial information complies with relevant regulations and statutory requirements;

   (c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

The audit report should contain a clear written opinion on the financial information and if the form or content of the report is laid down in or prescribed under any agreement or

statute or regulation, the audit report should comply with such requirements. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters stated above or as may be laid down or prescribed under the agreement or statute or regulation as the case may be.

When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matter is to be made, the audit report should state the reasons therefor.

1.9 SCOPE OF AUDIT

The scope of an audit as described in SA-200A on "Objective and Scope of the Audit of Financial Statements" is reproduced below :

The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.

The audit should be organized to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. To form an opinion on the financial statements, the auditor should be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. In forming his opinion, the auditor should also decide whether the relevant information is properly disclosed in the financial statements subject to statutory requirements, where applicable. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by :

(a) making a study and evaluation of accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures; and

(b) carrying out such other tests, enquiries and other verification procedures of accounting transactions and account balances as he considers appropriate in the particular circumstances.

The auditor determines whether the relevant information is properly disclosed in the financial statements by :

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

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

In forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operation results of the enterprise. The auditor recognizes that because of the test nature and other inherent limitations of an audit together with inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatements may remain undiscovered. While in many situations the discovery of material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions.

The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. However, it is difficult to lay down any definite standard by which materiality can be judged. Material items are those which might influence the decisions of the user of the financial statements. It is a matter in which a decision is arrived at on the basis of the auditor's professional experience and judgment.

The auditor is not expected to perform duties which fall outside the scope of his competence. For example, the professional skill required of an auditor does not include that of a technical expert for determining physical condition of certain assets.

Constraints on the scope of the audit of financial statements that impair the auditor's ability to express an unqualified opinion on such financial statement should be set out in his report, and a qualified opinion or disclaimer of opinion should be expressed as appropriate.

1.10 INHERENT LIMITATIONS OF AUDIT

At this stage, it must be clear that the objective of an audit of financial statements is to enable an auditor to express an opinion on such financial statements. In fact, it is the auditor's opinion which helps determination of the true and fair view of the financial position and operating results of an enterprise. It is very significant to note that the SA-200A makes it a subtle point that such an opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted affairs of the enterprise. Further, the process of auditing is such that it suffers from certain inherent limitations, *i.e.,* the limitation which cannot be overcome irrespective of the nature and extent of audit procedures. It is very important to understand these inherent limitations of an audit since understanding of the same would only provide clarity as to the overall objectives of an audit. The inherent limitations are :

(i) First of all, auditor's work involves exercise of judgment, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgment and estimates made by the management in preparing the financial statements. Further much of the evidence available to the auditor can enable him to draw only reasonable conclusions therefrom. The audit evidence obtained by an auditor is generally persuasive in nature rather than conclusive in nature. Because of these factors, the auditor can only express an opinion. Therefore, absolute certainty in auditing is rarely attainable. There is also likelyhood that some material misstatements of the financial information resulting from fraud or error, if either exists, may not be detected.

(ii) The entire audit process is generally dependent upon the existence of an effective system of internal control. Further, it is clearly evident that there always be some risk of an internal control system failing to operate as designed. No doubt, internal control system also suffers from certain inherent limitations. Any system of internal control may be ineffective against fraud involving collusion among employees or fraud committed by management. Certain levels of management may be in a position to override controls; for example, by directing subordinates to record transactions incorrectly or to conceal them, or by suppressing information relating to transactions. Such inherent limitations of internal control system also contribute to inherent limitations of an audit.

1.11 AUDITING AND INVESTIGATION

To understand auditing in its correct perspective, one should know how auditing is distinct from investigation.

Auditing is different from investigation which is another significant service, a professional accountant renders. Investigation is a critical examination of the accounts with a special purpose. For example if fraud is suspected and an accountant is called upon to check the accounts to whether fraud really exists and if so, the amount involved, the character of the enquiry changes into investigation. Investigation may be undertaken in numerous areas of accounts, *e.g.*, the extent of waste and loss, profitability, cost of production, etc. It normally concerns only specified areas, but at times, it may involve the whole field of accounting. Its essence lies in going into the matter with some pre-conceived notion suited to the objective. The techniques fit the circumstances of the case. For auditing on the other hand, the general objective is to find out whether the accounts show a true and fair view.

Audit never undertakes discovery of specific happenings and is never started with a pre-conceived notion about the state of affairs. The auditor seeks to report what he finds in the normal course of examination of the accounts adopting generally followed techniques unless circumstances call for a special probe : fraud, error, irregularity, whatever comes to the auditor's notice in the usual course of checking, are all looked into in depth and sometimes investigation results from the *prima facie* findings of the auditor.

1.12 TYPES OF AUDIT

Audit is not legally obligatory for all types of business organisations or institutions. On this basis audits may be of two broad categories *i.e.,* audit required under law and voluntary audits.

(i) Audit required under law: The organisations which require audit under law are the following:

- (a) companies governed by the Companies Act, 1956;
- (b) banking companies governed by the Banking Regulation Act, 1949;
- (c) electricity supply companies governed by the Electricity Supply Act, 1948;
- (d) co-operative societies registered under the Co-operative Societies Act, 1912;
- (e) public and charitable trusts registered under various Religious and Endowment Acts;
- (g) corporations set up under an Act of Parliament or State Legislature such as the Life Insurance Corporation of India.
- (h) Specified entities under various sections of the Income-tax Act, 1961.

(ii) In the voluntary category are the audits of the accounts of proprietary entities, partnership firms, Hindu undivided families, etc. In respect of such accounts, there is no basic legal requirement of audit. Many of such enterprises as a matter of internal rules require audit. Some may be required to get their accounts audited on the directives of Government for various purposes like sanction of grants, loans, etc. But the important motive for getting accounts audited lies in the advantages that follow from an independent professional audit. This is perhaps the reason why large numbers of proprietary and partnership business get their accounts audited. Government companies have some special features which will be seen later.

As already stated, the auditor should get the scope of his duties and responsibilities defined by obtaining instructions in writing. Also it is always a wise precaution to state in the report, accompanying the balance sheets of proprietary or partnership firms or other similar organisations, the nature of the work carried out and explain the important features of the financial statements on which a report has been made. Furthermore, to ensure that the report will be brought to the notice of all concerned, the accounts should bear reference to the report.

A special reference is necessary for non-profit making institutions like schools, clubs, hospitals. Most of these have some internal rules to govern their affairs and generally a provision about the requirement of audit is inserted. Activity in the nature of business is not altogether ruled out as a club may sell drinks and eatables to the members and their guests or a school may have endowed agricultural property to yield income. What makes them distinct, is the absence of the question of division of profit : any surplus which may arise can only be used for achieving the objects of the institution. Educational institutions, hospitals, associations, etc., irrespective of any internal rules, get their accounts audited because most of them enjoy government or municipal grants and, generally, for this purpose audited accounts are insisted upon.

Trust, however, stands on a slightly different footing; these may be public trusts or private trusts. Trusts can carry on business as well. In the majority of cases trustees are private persons. Trusts generally have two classes of beneficiaries; tenants for life and remainders; persons to whom the accounts is of the supreme importance are often widows and minors, who cannot criticise the accounts in any effective manner. Though audit of trusts, except for public trusts, is not compulsory most of the trust deeds contains a clause for audit of accounts. Private trustees also recognise the advantages of audit in their own interest, since any erroneous treatment in the accounts for which they might be personally liable will be pointed out by the auditor.

1.13 ADVANTAGES OF AN INDEPENDENT AUDIT

The fact that audit is compulsory by law, in certain cases by itself should show that there must be some positive utility in it. The chief utility of audit lies in reliable financial statements on the basis of which the state of affairs may be easy to understand. Apart from this obvious utility, there are other advantages of audit. Some or all of these are of considerable value even to those enterprises and organisations where audit is not compulsory, these advantages are given below :

(a) It safeguards the financial interest of persons who are not associated with the management of the entity, whether they are partners or shareholders.

(b) It acts as a moral check on the employees from committing defalcations or embezzlement.

(c) Audited statements of account are helpful in settling liability for taxes, negotiating loans and for determining the purchase consideration for a business.

(d) These are also useful for settling trade disputes for higher wages or bonus as well as claims in respect of damage suffered by property, by fire or some other calamity.

(e) An audit can also help in the detection of wastages and losses to show the different ways by which these might be checked, especially those that occur due to the absence or inadequacy of internal checks or internal control measures.

(g) Audit ascertains whether the necessary books of account and allied records have been properly kept and helps the client in making good deficiencies or inadequacies in this respect.

(h) As an appraisal function, audit reviews the existence and operations of various controls in the organisations and reports weaknesses, inadequacies, etc., in them.

(i) Audited accounts are of great help in the settlement of accounts at the time of admission or death of partner.

(j) Government may require audited and certified statement before it gives assistance or issues a licence for a particular trade.

1.14 RELATIONSHIP OF AUDITING WITH OTHER DISCIPLINES

The field of auditing as a discipline in simple words involves review of various assertions; both in financial as well as in non-financial terms, with a view to prove the veracity of such assertions and expression of opinion by auditor on the same. Thus, it is quite logical and natural that the function of audit can be performed if and only if the person also

possesses a good knowledge about the fields in respect of which he is conducting such a review.

1.14.1 Auditing and Accounting

It has been pointed out earlier that both accounting and auditing are closely related with each other as auditing reviews the financial statements which are nothing but a result of the overall accounting process. It naturally calls on the part of the auditor to have a thorough and sound knowledge of generally accepted principles of accounting before he can review the financial statements. In fact, auditing as a discipline is also closely related with various other disciplines as there is lot of linkages in the work which is done by an auditor in his day-to-day activities. To begin with, it may be noted that the discipline of auditing itself is a logical construct and everything done in auditing must be bound by the rules of logic. Ethical precepts are the foundations on which the foundation of the entire accounting profession rests. The knowledge of language is also considered essential in the field of auditing as the auditor shall be required to communicate, both in writing as well as orally, in day-to-day work.

1.14.2 Auditing and Law

The relationship between auditing and law is very close one. Auditing involves examination of various transactions from the view point of whether or not these have been properly entered into. It necessitates that an auditor should have a good knowledge of business laws affecting the entity. He should be familiar with the law of contracts, negotiable instruments, etc. The knowledge of taxation laws is also inevitable as entity is required to prepare their financial statements taking into account various provisions affected by various tax laws. In analysing the impact of various transactions particularly from the accounting aspect, an auditor ought to have a good knowledge about the direct as well as indirect tax laws.

1.14.3 Auditing and Economics

As is well known, accounting is concerned with the accumulation and presentation of data relating to economic activity. Though the concept of income as put forward by economists is different as compared to the accountants concept of income, still, there are lot of similar grounds on which the accounting has flourished. From the auditing view point, the auditors are more concerned with Micro economics rather than with the Macro economics. The knowledge of Macro economics should include the nature of economic force that affect the firm, relationship of price, productivity and the role of Government and

Government regulations. Auditor is expected to be familiar with the overall economic environment in which his client is operating.

1.14.4 Auditing and Behavioural Science

The discipline of behavioural science is also closely linked with the subject of auditing. While it may be said that an auditor, particularly the financial auditor, deals basically with the figures contained in the financial statements but he shall be required to interact with a lot of people in the organisation. As against the financial auditor, the internal auditor or a management auditor are expected to deal with human beings rather than financial figures. As it will be made clear in the chapter of 'Internal Control' that one of the basic elements in designing the internal control system is personnel. There it has been made amply clear that howsoever a sound internal control structure is designed, it cannot work until and unless the people who are working in the organisation are competent and honest. The knowledge of human behaviour is indeed very essential for an auditor so as to effectively discharge his duties.

1.14.5 Auditing and Statistics & Mathematics

With the passage of time, test check procedures in auditing have become part of generally accepted auditing procedures. With the emergence of test check procedure, discipline of statistics has come quite close to auditing as the auditor is also expected to have the knowledge of statistical sampling so as to arrive at meaningful conclusions. The knowledge of mathematics is also required on the part of auditor particularly at the time of verification of inventories.

1.14.6 Auditing and Data Processing

Today, organisations are witnessing revolution in the field of data processing of accounts. Many organisations are carrying out their financial accounting activities with the help of computers which can document, record, collate, allocate and value accounting data and information in very large quantity at very high speed. The dependence on the accuracy of the programmed instructions given today, the computer is able to carry out each of these activities with complete accuracy. With such a phenomenal growth in the field of computer sciences, the auditor should have good knowledge of the components, general capability of the system and the related terms. In fact, EDP auditing in itself is developing as a discipline in itself.

1.14.7 Auditing and Financial Management

Auditing is also closely related with other functional fields of business such as finance, production, marketing, personnel and other general areas of business management. With the overgrowing field of auditing, the financial services sectors occupies a dominant place in our system. While in general terms, the auditor is expected to have knowledge about various financial techniques such as working capital management, funds flow, ratio analysis, capital budgeting etc. The auditor is also expected to have a fair knowledge of the institutions that comprise the market place. The knowledge of various institutions and Government activities that influence the operations of the financial market are also required to be understood by an auditor.

1.14.8 Auditing and Production

Regarding production function, it may be stated that a good auditor is one who understands the client and his business. While carrying out the audit activity, the auditor is required to evaluate transactions from the accounting aspect in relation to the process through which it has passed through as accounting for by-products, joint-products may also require to be done. The knowledge of production process shall become more essential in case of an internal auditor. The auditor shall also require to understand the cost system in operation in the factory and assess whether the same is adequate for the particular company. The understanding of the terminology of the production shall enable an auditor to communicate with production employees in connection with his work.

On the similar pattern the auditor is also expected to have good understanding about the marketing, personnel and other general business management areas.

Self-Examination Questions

1. State which of the following statements are true :

   (i) Unless an auditor is able to discover all frauds and errors, he has not performed its main function.

   (ii) There is little difference between auditing and accounting as both deal with financial statements.

   (iii) An auditor is expected to point out to the management, flaws and loopholes in the system of accounting.

   (iv) Basically, an auditor reports on the truth or otherwise of the financial statements; prevention and detection of frauds and errors are secondary to this.

(v) The auditor compares entries in the books of account with the vouchers; and, if the two agree, his work is done.

(vi) Safeguarding the company's property is the function of management; hence the auditor is not concerned with verification of assets and liabilities.

(vii) The auditor must see to it that there is compliance with the Companies Act or other enactment, if applicable; otherwise, he has to mention the fact of non-compliance in his report.

(viii) Compliance with the accounting principles generally need not be insisted upon by the auditor.

(ix) Accounts become incorrect when the principle of double entry is not followed.

(x) There is no fraud if the cash used personally by the cashier is made up on demand by the management.

(xi) Fraud means misappropriation of goods or cash and artificial manipulation of accounts.

(xii) A balance sheet is true only on the day it is prepared.

(xiii) The auditor has to approach everyone with suspicion.

2. In each of the following cases mention the letter in the statement which will correctly complete the sentence :

(i) Audit under statute means : (a) an audit ordered by the Government; (b) an audit where duties, rights etc. of the auditor are laid down by law; (c) an audit of corporation in the public sector.

(ii) In case of audit of partnership or sole proprietorship : (a) the auditor's duties are defined purely by the contract between him and the client; (b) the auditor need not be as careful as in case of companies; (c) the audit must be as extensive as in case of companies.

(iii) An auditor appointed in place of another auditor should inform about the appointment : (a) to the other auditor; (b) Government; (c) the Institute of Chartered Accountants of India.

(iv) Investments received as security from an employee may be shown in the balance sheet as : (a) investment; (b) security deposit; (c) investment deposited by employees; (d) investments with nil value.

(v) If the management trusts an employees, the auditor should : (a) place implicit reliance on statements made by him; (*b*) see whether he is in a position and has the inclination to make statements correctly and truthfully; (*c*) put no reliance on the statements made by him.

3. Distinguish between concealed errors and apparent errors with illustrations.

4. Why are auditors generally required to express an opinion on the truth and fairness of the accounts and why they are not required to certify the accounts ?

5. Discuss the auditor's responsibility for the detection of fraud and error.

6. List the Statements on Standards Auditing Practices issued by the Institute of Chartered Accountants of India.

7. Messrs Auto Agencies, a partnership firm, approaches you and enquires whether it is necessary for them, under any statute or otherwise, to get their accounts audited.

   You are required to advise them, explaining briefly the objects and advantages of an audit of a partnership firm.

8. Offer your comments on the following *two* statements :-

   (a) Detection of frauds and errors is not the objective of audit.

   (b) An audit is not concerned with the propriety of business conduct.

9. It appears from a number of studies in recent years that the role of an auditor in relation to the detection of fraud is widely misunderstood. These studies have found that a high proportion of investors and of company management believes that the detection of fraud is one of the main objectives of an audit. Required :

   (a) Discuss what you consider to be the auditor's responsibilities, in the course of the normal annual audit, in relation to the detection of fraud.

   (b) Explain the way in which the auditor should approach and perform his work in order to meet those responsibilities.

10. Audit of the accounts of the sole-proprietor is not compulsory. However, he may get his books of account audited for various reasons. Discuss.

11. (a) What are the objectives of audit ?

    (b) What is the importance of having the accounts audited by an independent professional auditor ?

12. Comment on the following statements :

    (a) Auditor is responsible for expressing opinion on financial statements in statutory audit,

    (b) Generally an audit is not concerned with the propriety of business conduct.

Multiple Choice Questions

1. Scope paragraph is —

    (a) describing the nature of an audit

    (b) is a reference to the auditing standards

    (c) a description of the work performed by the auditor

    (d) all of the above

2. "Scope" – SA 200A refers to the —

    (a) auditors ability

    (b) directors ability

    (c) partners ability

    (d) employees ability

3. The date of auditor's report on the financial statements is the —

    (a) date on which the auditor signs

    (b) date of the financial statements

    (c) date of submission of the statements to the client

    (d) date of submission of the statements to the required parties

4. Where the firm is appointed as the auditor, the report should be signed in the —

    (a) personal name of the auditor

    (b) personal name of the auditor and in the name of the audit firm

    (c) personal name of the auditor or in the name of the audit firm

    (d) name of the audit firm

5. The report should name specific location, which is ordinarily the city where the —
   (a) audit report is signed
   (b) audit report is prepared
   (c) operations of the company takes place
   (d) head office of the company is located
6. The main object of an audit is —
   (a) expression of opinion
   (b) detection and prevention of fraud and error
   (c) both a and b
   (d) depends on the type of audit
7. The title of SA 200A issued by Council of ICAI is —
   (a) objective and scope of the Financial Statements
   (b) objective and scope of the Audit of Financial Statements
   (c) objective and scope of Business of an Entity
   (d) objective and scope of Financial Statements Audit
8. Which of the following is not true about auditor's duty ?
   (a) The auditor should express an opinion on financial statements
   (b) His opinion is no guarantee to future viability of business
   (c) He is responsible for detection and prevention of frauds and errors in financial statements
   (d) He should examine whether recognised accounting principals have been consistently followed
9. A sales of Rs.1,00,000 to A was entered as sales to B. This is an example of —
   (a) error of omission
   (b) error of commission
   (c) compensating error
   (d) error of principle

10. Goods sent on approval" have been recorded as "Credit Sales. This is an example of —
    (a) error of omission
    (b) error of commission
    (c) error of Principle
    (d) error of duplication
11. Which of the following statements is not true ?
    (a) Management fraud is more difficult to detect than employee fraud
    (b) Internal control system reduces the possibility of occurrence of employee fraud and management fraud
    (c) The auditor's responsibility for detection and prevention of errors and frauds is similar
    (d) all statements are correct
12. As per SA 240 if auditor detects an error then —
    (a) he should inform the management
    (b) he should communicate it to the management if it is material.
    (c) the auditor should ensure financial statements are adjusted for detected errors
    (d) both b and c
13. Which of the following is not limitation of audit as per AAS 4 ?
    (a) Objectivity of auditor's judgment
    (b) Selective testing
    (c) Persuasiveness of evidence
    (d) Limitations of internal control system
14. How many principles are listed in AAS 1 which govern auditor's professional obligation ?
    (a) Seven
    (b) Eight
    (c) Nine
    (d) Fourteen

15. Both auditing and accounting concerned with financial statements. Which of the following statement(s) best explain their relationship —

    (a) Auditing lends credibility dimension and quality to verify the financial information made available by accountancy

    (b) Auditing uses the theory of evidence to verify the financial information made available by accountancy

    (c) Auditor should have thorough knowledge of accounting concepts and convention to enable him to express an opinion of financial statements

    (d) All of the above

16. The risk of management fraud increases in the presence of —

    (a) frequent changes in supplies

    (b) improved internal control system

    (c) substantial increase in sales

    (d) management incentive system based on sales done in quarter

17. Auditing standards differ from audit procedures in that procedures relate to —

    (a) audit assumptions

    (b) acts to be performed

    (c) quality criterion

    (d) methods of work

18. Which of the following factors is likely to be identified as a fraud risk factor by the auditor ?

    (a) The company is planning a initial public offer of quality shares to raise additional capital for expansion

    (b) Bank reconciliation statement includes

    (c) deposits-in-transit Plant and machinery sold at a loss

    (d) The company has made political contributions

19. The most difficult type of misstatement to detect fraud is based on —

    (a) Related party purchases

    (b) Related party sales

    (c) The restatement of sales

    (d) Omission of a sales transaction from being recorded

20. Which of the following statements is correct concerning the required documentation in working papers of fraud risk assessment undertaken by the auditor ?

    (a) All risk factors, as mentioned in AAS 4, should be considered and documented along with response to them.

    (b) Document the identification of fraud risk factors along with response to them

    (c) Document material fraud risk factors and response to them

    (d) No documentation is required

21. Which of the following statements is the most appropriate potential reaction of the auditor to his assessment that the risk of material misstatement due to fraud is high in relation to existence of inventory ?

    (a) Visit location on surprise basis to observe test counts

    (b) Request inventory count at a date close to year-end

    (c) Vouch goods sent on approval very carefully

    (d) Perform analytical procedures

22. Which of the following statements in not likely to be a fraud risk factor relating to management's characteristics —

    (a) Tax evasion

    (b) Failure to correct known weakness in internal control system

    (c) Adoption of conservative accounting principles

    (d) High management turnover

23. Which of the following statements not impair auditor's independence ?

    (a) Taking up tax consultancy work with the client

(b) Taking up consultancy work related to establishment of cost accounting system for valuation of inventory

(c) Making suggestions that are adopted about the form and content of an entity's financial statements.

(d) both a and c

24. Professional skepticism requires that the auditor assume that management is —

(a) Management is reasonably honest

(b) Neither honest nor dishonest

(c) Not necessarily honest

(d) Dishonest unless proved otherwise

25. Audit of banks is an example of —

(a) statutory audit

(b) balance sheet audit

(c) concurrent audit

(d) all of the above

26. Concurrent audit is a part of —

(a) internal check system

(b) coutinuous audit

(c) internal audit system

(d) non of the above.

27. In India, balance sheet audit is synonymous to —

(a) annual audit

(b) continuous audit

(c) detailed audit

(d) statutory audit

28. Audit in depth is a synonymous for —

(a) complete audit

(b) completed audit

(c) final audit

(d) detailed audit

29. Balance audit includes verification of —

(a) assets

(b) liabilities

(c) income and expense accounts where appropriate

(d) All of the above

30. Which of the following statements is not true about continuous audit ?

(a) it is conducted at regular or irregular interval.

(b) it may be carried out on a daily basis.

(c) it is needed when the organisation has a good internal control system

(d) it is expensive

31. Which of the following is not a facet EPA —

(a) economy audit

(b) efficiency audit

(c) expenditure audit

(d) effectiveness audit

32. The Delhi Government had constructed 6 bungalows for its ministers. They are lying unoccupied for last three years. This would be a matter of concern for —

(a) Proprietory auditor

(b) performance auditor

(c) financial auditor

(d) none of the above.

33. Balance sheet does not include

(a) verification of assets and liabilities

(b) vouching of income and expense accounts related to assets and liabilities.

(c) examination of adjusting and closing entries.

(d) routine checks

34. Which of the following auditing and assurance standard deals with audit planning ?

(a) AAS-7

(b) AAS-8

(c) AAS-9

(d) AAS-3

35. Audit programme is prepared by —

(a) the auditor

(b) the client

(c) the audit assistants

(d) the auditor and his audit assistants

36. The quantity of audit working papers compiled on engagement would most be affected by—

(a) management's integrity

(b) auditor's experience and professional judgement

(c) auditor's qualification

(d) control risk

37. Which of the following information should a successor auditors obtain during the inquiry of the predecessor auditor before accepting engagement ?

i. Information about integrity of management

ii. disagreement with management concerning auditing

iii. procedures review of internal control system Organisation structure –

(a) (i) and (ii);

(b) (ii) and (iii);

(c) (i), (ii) and (iii);

(d) (i) and (iii)

38. The audit engagement letter, generally, should include a reference to each of the following except —

(a) limitations of auditing

(b) responsibilities of management with respect to audit work

(c) expectation of receiving a written management representation letter

(d) a description of the auditor's method of sample selection

39. The use of an audit engagement letter is the best method of assuring the auditor will have which of the following —

(a) auditor will obtain sufficient, appropriate audit evidence

(b) management representation letter

(c) access to all books, accounts, and vouchers required for audit purpose

(d) cooperation from other auditors

CHAPTER 2

BASIC CONCEPTS IN AUDITING

Learning Objectives

After reading this chapter, you will in a position to understand –

- The concepts of auditor's independence
- Audit evidence and the procedures to obtain audit evidence.
- Materiality, concepts of true and fair and disclosure of accounting policies.

2.1 CONCEPT OF AUDITOR'S INDEPENDENCE

Professional accountants have an important role in society. Investors, creditors, employers and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and behaviour of professional accountants in providing such services have an impact on the economic well-being of their community and country. Professional accountants can remain in this advantageous position only by continuing to provide the public with these unique services at a level which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with ethical requirements that strive to ensure such performance. In order to achieve the objectives of the accountancy profession, professional accountants have to observe a number of prerequisites or fundamental principles as under:

Integrity: A professional accountant should be straightforward and honest in performing professional services.

Objectivity: A professional accountant should be fair and should not allow prejudice or bias, conflict of interest or influence of others to override objectivity.

Professional Competence and Due Care: A professional accountant should perform professional services with due care, competence and diligence and has a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives the advantage of competent professional service based on up-to-date developments in practice, legislation and techniques.

Confidentiality: A professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose any such information without proper and specific authority or unless there is a legal or professional right or duty to disclose.

Professional Behaviour: A professional accountant should act in a manner consistent with the good reputation of the profession and refrain from any conduct which might bring discredit to the profession.

Technical Standards: A professional accountant should carry out professional services in accordance with the relevant technical and professional standards. Professional accountants have a duty to carry out with care and skill, the instructions of the client or employer insofar as they are compatible with the requirements of integrity, objectivity and, in the case of professional accountants in public practice, independence.

Independence is the keystone upon which the respect and dignity of a profession is based. Independence stands for the strength of individuals to adopt an unbiased view on the matters undaunted by any favour or frown. In all matters relating to the assignment, an independence in mental attitude is to be maintained. Only so long as the auditor maintains a high standard of independence and impartiality, the audit reports will continue to be accepted and respected by business, financial institutions, Government and investors. Professional integrity and independence are essential characteristics of all the learned professions but are more so in the case of accounting profession.

Independence is a state of mind and personal character and an enlightened view of the professional duties involved. Independence is much affected by the state of the profession, *i.e.,* the ability and willingness to enforce a proper code of ethics as well as its ability to withstand pressures. The more the esteem for the profession in the public eyes because of the standards of independence prescribed by it for its members, greater the reliance there would be on the reports and opinions given by the members of the profession. Independence, as has been stated earlier, is a qualitative condition but rules are often framed by professional bodies to help and guide members in preserving independence in variety of complex circumstances.

Independence of auditor must not only exist in fact, but should also appear to exist to all reasonable persons. This is very important because very often the relationships are misunderstood. It is, therefore, necessary that relationship maintained by the auditor shall be such that no reasonable man can doubt his objectivity and integrity.

The Guidance Note issued by the ICAI on "Independence of Auditors" contemplates that it is not possible to define "Independence" precisely. According to it, "independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self-interest. It stipulates that the independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered. Independence of the auditor has not only to exist in fact, but should also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly he himself is satisfied about his client and secondly, no unbiased person would be forced to the conclusion that on an objective assessment of the circumstances, there is likely to be an abridgment of the auditors' independence. There is also a collective aspect of independence that is important to the accounting profession as a whole.

The chartered accountant is not personally known to the third parties who rely on professional opinion and accept his opinion principally on a larger faith on the entire accounting profession.

The Companies Act, 1956 has enacted specific provisions to give concrete shape to this vital concept. The provisions disqualifying certain types of persons from undertaking audit of limited companies, provisions relating to ceiling on the number of audits that can be undertaken by chartered accountant, provisions requiring special resolution for appointing auditors in certain cases and other provisions on appointment, reappointment and removal of auditors are designed to invest this institution of audit with sufficient independence to carry out the audit in the larger interest of shareholders and other users. The vast powers of access given to the auditor to the books of account and other documents of the company are specifically designed to give independence to the auditors. The power to qualify his report is yet another weapon in the armoury of the auditor to protect his independence. The enactment of specific instances of misconduct in the Schedules to the Chartered Accountants Act, 1949 is yet another attempt to keep the independence and professional competence of the accounting profession.

In order to ensure independence, the law has also made certain provisions which put either prohibitions or regulations in the matter of appointment of auditors -

Accordingly a person is disqualified to act as an auditor from being appointed as such if he is :

(i) an officer or employee of the company;

(ii) a partner or an employee of an officer or employee of the company; or

(iii) indebted to the company for a sum exceeding of Rs. 1,000.

(iv) a person holding any security (any financial instrument which carried voting rights) of that company after a period of one year from the date of the commencement of the Companies (Amendment) Act, 2000.

The following are some specific instances where the question of independence *vis a vis* indebtedness has been considered :

1. The Research Committee of the ICAI has expressed the opinion that where in accordance with the terms of his engagement by a client the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job, he cannot be said to be indebted to the company at any stage.
2. Where an auditor purchases goods or services from a company audited by him on credit he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand he is disqualified for appointment as an auditor of the company and has to vacate his office. It will not make any difference if the company allows him the period of credit as it allows to other customers in the normal business. He, in fact, in such a case also has become indebted to the company and consequently has to vacate his office.
3. A partner is disqualified when a firm in which he is a partner is indebted to the company for a sum exceeding rupees one thousand. Similarly, a firm is disqualified if a partner of that firm is so indebted.

2.2 AUDIT EVIDENCE

2.2.1 Introduction

Auditing is a logical process. An auditor is called upon to assess the actualities of the situation, review the statements of account and give an expert opinion about the truthness and fairness of such accounts. This he cannot do unless he has examined the financial statements objectively.

Objective examination connotes critical examination and scrutiny of the accounting statements of the undertaking with a view to assessing how far the statements present the actual state of affairs in the correct context and whether they give a true and fair view about the financial results and state of affairs. An opinion founded on a rather reckless and negligent examination and evaluation may expose the auditor to legal action with consequential loss of professional standing and prestige.

He needs evidence to obtain information for arriving at his judgment. Statements of account are mainly two : one dealing with the revenue earning activity and the other showing the consequential position of assets and liabilities. The former in our country is known as "profit and loss account" and the latter "balance sheet". In each case there are a number of items, which are in fact account heads under which the various transactions are classified for a correct evaluation of the state of affairs; the examination process should aim at verification of each such item.

SA-200 on Basic Principles Governing an Audit states, "the auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information". SA-500 on Audit Evidence further expounds this concept. According to it, sufficiency and appropriateness are inter-related and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained while appropriateness relates to its relevance and reliability. Normally, the auditor finds it necessary to rely on audit evidence which is persuasive rather than conclusive. He may often seek evidence from different sources or of different nature to support the same assertions. The various factors which influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under :

(a) The degree of risk of misstatement which may be affected by factors such as :
    (i) the nature of the item;
    (ii) the adequacy of internal control;
    (iii) the nature or size of the business carried on by the entity;
    (iv) situations which may exert an unusual influence on management;
    (v) the financial position of the entity.
(b) The materiality of the item.
(c) The experience gained during previous audits.

(d) The results of auditing procedures, including fraud and errors which may have been found.

(e) The type of information available.

(f) The trend indicated by accounting ratios and analysis.

The auditor obtains evidence through compliance procedures and substantive procedures to satisfy assertions contained in the financial statements.

2.2.2 Audit Procedures to Obtain Audit Evidence

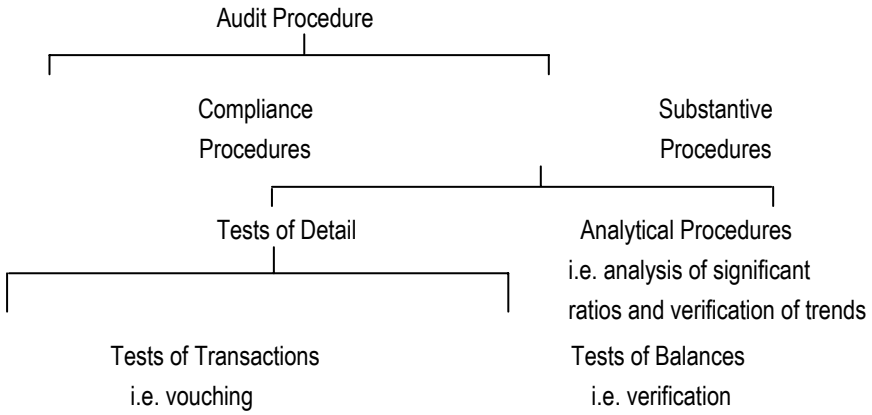
Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. In obtaining audit evidence from compliance procedures, the auditor is concerned with assertions that the control exists, the control is operating effectively and the control has so operated throughout the period of intended reliance. So the auditor is concerned with the existence, effectiveness and continuity of the control system.

Substantive procedures are tests designed to obtain evidence as to the completeness, accuracy and validity of the data produced by accounting system. They are of two types :

(1) tests of details of transactions and balances.

(2) analysis of significant ratios and trends including the resulting investigation of unusual fluctuations and items.

The following chart illustrates different audit procedures :



In obtaining audit evidence from substantive procedures, the auditor is concerned with the following assertions:

Existence - an asset or liability exists at a given date.

Rights and obligations - an asset is a right of the entity and a liability is an obligation of the entity at a given date.

Occurrence - a transaction or event took place which pertains to the entity.

Completeness - there are no unrecorded assets, liabilities or transactions.

Valuation - an asset or liability is recorded at an appropriate carrying value.

Measurement - a transaction is recorded in the proper amount and revenue or expense is allocated to the proper period.

Presentation - an item is disclosed, classified and described in accordance with the acceptable accounting policies and, when applicable, legal requirements.

Let us elaborate this with the help of two illustrations. We must clearly understand that each item contained in financial statements asserts something to the readers of the accounts to indicate the ownership, existence, quantity of various things, etc. Auditing is concerned with the testing of the authenticity of the information thus conveyed. For example, when we find in the balance sheet, an item under current assets reading as "cash in hand - Rs. 8,000" the obvious assertions that would strike the mind are the following :

(i) the firm concerned had Rs. 8,000 in hand in valid notes and coins on the balance sheet day;

(ii) that the cash was free and available for expenditure to the firm; and

(iii) that the books of account show a cash balance of identical amount at the end of the day on which the balances sheet is drawn up.

Take another example :

		Rs.
Plant and Machinery (at cost)		2,00,000
Less: Depreciation till the end of previous year	70,000	
Depreciation for the year	13,000	83,000
		1,17,000

The assertions are as follows :

(i) the firm owns the plant and machinery;

(ii) the historical cost of plant and machinery is Rs. 2 lacs;

(iii) the plant and machinery physically exists;

(iv) the asset is being utilised in the business of the company productively;

(v) total charge of depreciation on this asset is Rs. 83,000 to date on which Rs. 13,000 relates to the year in respect of which the accounts are drawn up; and

(vi) the amount of depreciation, has been calculated on recognised basis and the calculation is correct.

From the above two illustrations we know the sort of assertions that are implied in the financial statements. Incidentally, the assertions are generally implied and not specifically spelt out, though some explicit assertions are also found in the financial statements. Explicit assertions are made when otherwise the reader will be left with an incomplete picture; it may even be misleading. An example of the former category may be found in the following items appearing in the liability side of the balance sheet :

Secured Loans Rs. 4,00,000

The description does not give us a complete picture. We do not know :

(i) the name of the lender, if it is relevant;

(ii) the nature of security provided; and

(iii) the rate at which interest in payable.

A specific mention is required about these things for a proper appreciation of the item and the financial position. Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as “building”, it would be an implied negative assertion that the entity did not own any building on the balance sheet date.

Every financial statement contains an overall representation in addition to the specific assertions so far discussed. Each financial statement purports to present something as a whole in addition to its component details. For example, an income statement purports to present “the results of operations” a balance sheet purports to present “financial position”. The auditor’s opinion is typically directed to these overall representations. But to formulate and offer an opinion on the overall truth of these statements he has first to inquire into the truth of many specific assertions, expressed and implied, both positive, and negative, that make up each of these statements. Out of his individual judgments of these specific assertions he arrives at a judgment on the financial statement as a whole.

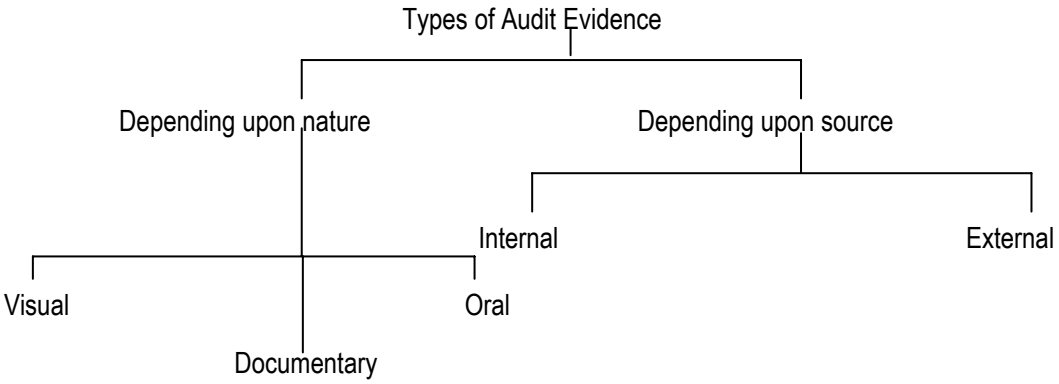
Some observations about audit evidence may be of help in deciding upon the techniques to be adopted for obtaining them. *First,* there is nothing mysterious about the evidence

which an auditor can obtain and on which he relies; it is straight forward information, some of it is obtained only by diligent effort but all of it is of the common sense variety. *Second,* evidence varies in reliability. When the auditor recalculates certain figures, like depreciation or inventory valuation, he may be completely convinced about the reliability of the company's figure. However information supplied by an employee may not be that reliable because he may have an interest in concealing rather than revealing the truth. This suggests that we must always be alert to the relative reliability of different kinds of evidence. *Third,* some evidence may be more difficult to obtain than other. It is relatively easy to put questions to employees who are present inside the company. It is easy to examine inventory on hand; it is more difficult to verify inventory stored elsewhere. *Fourth,* it must be recognised that the available evidence be persuasive and that the evidence may not be conclusive. In giving the opinion, the auditor necessarily take a calculated risk. He gets the best evidence reasonably available and forms his judgment accordingly. In fact, in auditing it is very difficult and at times impracticable to obtain conclusive evidence both on account of time and cost constraints. This explains why an auditor gives an opinion rather than some kind of guarantee or certificate. All he can state is that he has carefully examined the various assertions in the financial statements, obtained evidence what he, in his professional judgment, thought adequate or the best available; and that he has considered that evidence judiciously in forming an opinion as to the reliability of the financial statements. *Fifth,* the auditor may gain increased assurance when audit evidence obtained from different sources of a different nature is consistent. In the circumstances, he may obtain a cumulative degree of assurance higher than that which he attaches to the individual items of evidence by themselves. Conversely when audit evidence obtained from one source is inconsistent with that obtained from another further procedures may have to be performed to resolve the inconsistency. *Sixth,* the auditor should be thorough in his efforts to obtain evidence and be objective in its evaluation. In selecting procedures to obtain evidence, he should recognize the possibility that the financial information may be materially misstated. *Seventh,* there should be a rational relationship between the cost of obtaining evidence and the usefulness of the information obtained. However, the matter of difficulty and expenses involved in testing a particular item is not in itself a valid basis for omitting a procedure. *Eight,* when the auditor is in reasonable doubt as to any assertion of material significance, he should attempt to obtain sufficient appropriate evidence to remove such doubt. If he is unable to obtain sufficient appropriate evidence, he should not express an unqualified opinion.

2.2.3 Types of Audit Evidence

Internal evidence and external evidence : Evidence which originates within the organisation being audited is an internal evidence. **Example**-sales invoice. Copies of sales challan and forwarding notes, goods received note, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organisation; for example, purchase invoice, supplier's challan and forwarding note, debit notes and credit notes coming from parties, quotations, confirmations, etc.



In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence *e.g.* an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

2.2.4 Reliability of Audit Evidence

The reliability of audit evidence is influenced by its source — internal or external and by it nature–visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained the following generalizations may be useful in assessing the reliability of audit evidence :

(i) External evidence (e.g., confirmation received from a third party) is more reliable than internal evidence.

(ii) Internal evidence is more reliable when related internal control is satisfactory.

(iii) Evidence obtained by the auditor himself is more reliable than that obtained from the entity.

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

Best evidence : It is essentially a theoretical concept and normally not available in audit situations. Best evidence exercises compelling influence over the mind of the investigator or the auditor. Normally an auditor relies on *prima facie* evidence which is normally available and it is considered adequate in the absence of suspicious circumstances. In case of suspicious circumstances, however, the auditor should look for more compelling evidence and should attempt to obtain as much corroborative evidence as may be available. For example if there are reasons to suspect the figures of the creditors, the auditor should not only go for balance confirmation but also the statements of account received from the creditor, subsequent payments, tracing of the supplies received to the stock records, etc.

2.2.5 Methods to Obtain Audit Evidence

The auditor obtains evidence in performing compliance and substantive procedures by one or more of the following methods:

(i) inspection;

(ii) observation;

(iii) inquiry and confirmation;

(iv) computation; and

(v) analytical review.

The timing of such procedures will be dependent, in part, upon the periods of time during which the audit evidence sought is available.

Inspection : Inspection consists of examining records, documents or tangible assets. Inspection or records and documents provides evidence of varying degrees of reliability depending on their nature and source and the effectiveness of internal control over their processing. Three major categories of documentary evidence which provide different degrees of reliability to the auditor are:

(i) documentary evidence created and held by the third parties;

(ii) documentary evidence created by third parties and held by the entity; and

(iii) documentary evidence created and held by the entity. Inspection of tangible assets provides reliable evidence with respect to their existence but not necessarily as to their ownership or value.

Observation : Observation consists of looking at a process a procedure being performed by the others. For example, the auditor may observe the counting of inventories by client personnel or the performance of internal control procedures that leave no audit trial.

Inquiry and confirmation : Inquiry consists of seeking appropriate information from knowledgeable person inside or outside the entity. Queries may range from formal written inquires addressed to third parties to informal oral inquires addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may provide him with corroborative evidence.

Confirmation consists of the response to an inquiry to corroborate information in the accounting records. For example, the auditor normally requests confirmation of receivable by direct communication with debtors.

Computation : Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations.

Analytical Review : Analytical review consists of studying significant ratios and trends and investigating unusual fluctuation and item.

Process of judgment formation by auditor : After the audit, the auditor issues his report which contains his opinion on the state of affairs the accounts are depicting. The opinion that the auditor expresses is the result of exercise of judgment by him on facts, evidence and circumstances he has come across in the course of audit. The judgment is formed on the undernoted basis :

1. Identification of the assertions to be examined.
2. Evaluation of the assertions as to relative importance.

3. Collections of the necessary information or evidence about the assertions to enable him to give an informed opinion.
4. Evaluation of the evidence as valid or not valid, pertinent or not pertinent, sufficient or not sufficient.
5. Formulation of judgment as to fairness of the assertions under consideration.

2.3 CONCEPT OF MATERIALITY

The concept of materiality is fundamental to the process of accounting. It covers all the stages from the recording to classification and presentation. It is, therefore, an important and relevant consideration for an auditor who has constantly to judge whether a particular item or transaction is material or not. SA-320 on Audit Materiality lays down standard on the concept of materiality and its relationship with audit risk. (Students may note that there is SA-400 on Audit Risk). SA-320 requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Infact, the auditor would be required to assess materiality right from the stage of planning the audit till the final stage of reaching at his opinion. Obviously, an auditor requires more reliable evidence in support of material items. He also has to ensure that such items are properly and distinctly disclosed in the financial statements.

"Accounting Standard 1 defines, material items as relatively important and relevant items, *i.e.* "items the knowledge of which would influence the decisions of the users of the financial statements". Whether or not the knowledge of an item would influence the decisions of the users of the financial statements is dependent on the particular facts and circumstances of each case. It is not possible to lay down precisely either in terms of specific account or in terms of amounts the items which could be considered as material in all circumstances. Materiality is a relative term and what may be material in one circumstance may not be material in another. Therefore, the decision to judge the materiality of the item whether in the aggregation of items, presentation or classification of items shall depend upon the judgment of preparers of the account on the circumstances of the particular case. In many cases percentage comparison may be useful in indicating the materiality of an item. For example, Part II of Schedule VI to the Companies Act, 1956 requires that any expense exceeding one per cent of the total revenue of the company or Rs. 5,000 whichever is higher, shall be shown as a separate and distinct item under an appropriate account head in the profit and loss account and shall not be combined with any other item to be shown under miscellaneous expenses. Similarly, if an item account for 10% or more of the total value of raw material consumed, it has to be shown separately and distinctively. Further, Part II of Schedule IV also requires that profit and

loss account shall disclose every material feature including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature. Actually the detailed disclosure requirements of Schedule VI to the Companies Act, 1956 seek to ensure that the financial statements disclose all material items so as to give a true and fair view of the state of affairs of the company. Apart from the percentage criterion, the relative significance of an item has to be viewed from many angles while judging its materiality. It is generally felt that in respect of items appearing in the profit and loss account and having an effect on the profit for the year, materiality should be judged in relation to the group to which the asset or the liability belongs, for example, for any item of current asset in relation to total current assets and any item of current liability in relation to total current liabilities. Another angle to judge the materiality of the item can be to compare it with the corresponding figure in the previous year. Suppose the item is of a low amount this year but it was of a much higher amount in the previous year then it becomes material when compared to the corresponding figure of the previous year. Thus, materiality of an item can be judged : (*a*) from the impact that the item has on the profit or loss or on the balance sheet, or on the total of the category of items to which it pertains, and (*b*) on its comparison with the corresponding figure of the previous year. In many circumstances even small amount may be considered material. Thus, if there is a statutory requirement of disclosure of amount paid as sitting fee to directors the amount so paid must be disclosed precisely and separately. Similarly, a payment of Rs. 100 to directors as remuneration in excess of statutory limits may be material. A small inaccuracy may be considered material if it further depresses or boosts a low profit or converts a small loss into a profit or *vice versa*. Similarly, if it creates or eliminates a margin of insolvency in the balance sheet, it will be a material item. Transaction of abnormal or non-recurring nature are also considered material even though the amount involved may not be significant. In off-setting and aggregating items, care must be taken to see that items which are independently material are not set-off against each other. For example, the surplus arising from a change in the basis of accounting may not be set-off against a non-recurring loss. Even as item with a *nil* or small balance may assume materiality in a situation where it was not expected to be *nil* or insignificant.

Thus, materiality, is an important and relevant consideration for the auditor also because he has to evaluate whether an item is material in giving or distorting a true and fair view of financial statement. He also has to ensure that a material item is disclosed separately and distinctly or atleast clear information about the item is available in the accounting statements.

The relationship between audit materiality and risk is explained in Chapter 3.

2.4 CONCEPT OF TRUE AND FAIR

The concept of true and fair is a fundamental concept in auditing. The phrase "true and fair" in the auditor's report signifies that the auditor is required to express his opinion as to whether the state of affairs and the results of the entity as ascertained by him in the course of his audit are truly and fairly represented in the accounts under audit. This requires that the auditor should examine the accounts with a view to verify that all assets, liabilities, income and expenses are stated as amounts which are in accordance with accounting principles and policies which are relevant and no material amount, item or transaction has been omitted. What constitutes "true and fair," however, has not been defined in any legislation. In the context of audit of a company, however, section 211(5) of the Companies Act provides that the accounts of a company shall be deemed as not disclosing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of provisions of Schedule VI to that Act, or by virtue of a notification or an order of the Central Government modifying the disclosure requirements. Therefore, the auditor will have to see that the accounts are drawn up in conformity with the provisions of Schedule VI and whether they contain all the matters required to be disclosed therein. In case of companies which are governed by special Acts, the auditor should see whether the disclosure requirements of the governing Act are complied with. Section 209(3) of the Companies Act, 1956 also contemplates that a company shall not be deemed to be maintaining proper books of account to show a true and fair accrual basis of accounting. It must be noted that the disclosure requirements laid down by the law are the minimum requirements. If certain information is vital for showing a true and fair view, the accounts should disclose it even though there may not be a specific legal provision to do so. Thus, what constitutes a 'true and fair' view is a matter of an auditor's judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see : (*i*) that the assets are neither undervalued or overvalued, according to the applicable accounting principles, (*ii*) no material asset is omitted; (*iii*) the charge, if any, on assets are disclosed; (*iv*) material liabilities should not be omitted; (*v*) the profit and loss account discloses all the matters required to be disclosed by Part II of Schedule VI and the balance sheet has been prepared in accordance with Part I of Schedule VI; (*vii*) accounting policies have been followed consistently; and (*viii*) all unusual, exceptional or non-recurring items have been disclosed separately.

In this context, it is noteworthy that the Council of the Institute while issuing a clarification regarding authority attached to documents issued by the Institute also observed that, "The Companies Act 1956, as well as many other statutes require that the financial statements of an enterprise should give a true and fair view of its financial position and working

results. This requirement is implicit even in the absence of a specific statutory provision to this effect. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 1956 or in any other statute. The pronouncements of the Institute seek to describe the accounting principles and the methods of applying these principles in the preparation and presentation of financial statements so that they give a true and fair view. The pronouncements issued by the Institute includes various statements, standards and guidance notes.

Directors Responsibility Statement under section 217(2AA) requires that the Board's Report shall state that, "that the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for that period".

2.5 DISCLOSURE OF ACCOUNTING POLICIES

2.5.1 Nature of Accounting Policies

Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

There is no single list of accounting policies which are applicable to all circumstances. The different circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

The various statements of the Institute of chartered accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternative particularly in the case of a corporate enterprise. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those stances faced by the enterprises.

2.5.2 Areas in which Different Accounting Policies are Encountered

The following are examples of the areas as given in AS 1, Disclosure of Accounting Policies in which different accounting policies may be adopted by different enterprises.



- Methods of depreciation, depletion and amortisation
- Treatment of expenditure during construction
- Conversion or translation of foreign currency items
- Valuation of inventories
- Treatment of goodwill
- Valuation of investments
- Treatment of retirement benefits
- Recognition of profit on long-term contracts
- Valuation of fixed assets
- Treatment of contingent liabilities

2.5.3 Disclosure of Accounting Policies

The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.

The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.

The purpose of AS-1 is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed. Such disclosure should form part of the financial statements.

It would be helpful to the reader of financial statements if they are all disclosed at one place instead of being scattered over several statements, schedules and notes and form part of financial statements.

Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

2.5.4 Fundamental Accounting Assumptions

Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.

The following have been generally accepted as fundamental accounting assumptions :

(a) *Going Concern* : The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing.

(b) *Consistency* : It is assumed that accounting policies are consistent from one period to another.

(c) *Accrual* : Revenues and costs are accrued, that is recognised as they are earned or incurred (and not as money is received or paid) and recognised in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this statement.)

If the fundamental accounting assumptions, *viz*., Going concern, Consistency and Accrual are followed in financial statements specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

Self-examinationQuestions

1. Will you accept the following as good vouchers ?
   (a) a cash memo for Rs. 250 for a perambulator of a company producing rolled steel;
   (b) a statement of account received from a creditor claiming an amount of Rs. 560 as balance due to him; the amount has been debited to the Purchases Account;
   (c) an invoice of Rs. 1,840, on account of new typewriter; the invoice has been issued by a person employed in a commercial concern;
   (d) a bill for travelling allowance submitted by a salesman;

(e) a statement of account from clearing agents claiming Rs. 1,000 as customs duty paid on behalf of the client;

(f) rent receipt for a house at Simla the company having its office and factory at Delhi;

(g) club bills submitted by the sale manager; and

(h) travelling allowance bills of the manager for attending meeting convened by the Government for public cause.

If you will reject the voucher, state your reasons.

2. Define compliance tests and substantive tests.
3. Define internal evidence and external evidence.
4. What are the various methods of obtaining audit evidence ?
5. Give the type or types of evidence generally available in respect of the following :
   (a) Goods in-transit
   (b) Leasehold land
   (c) Returns Inward
   (d) Balance with bank
   (e) Materials received from customers for fabrication.
   (f) Construction work-in-progress.
   (g) Contingent liability in respect of uncalled amount on investment in shares.
6. Suggest evidence in respect of the following :
   (i) Fees paid to directors
   (ii) Balance with banks
   (iii) Furniture & fittings
   (iv) Royalty paid to Japanese collaborator.
   (v) Investment lodged as earnest money deposit.
7. Discuss the importance of the concept of materiality for the auditor.
8. Discuss the concept of True and Fair.
9. "It is the duty of every auditor to familiarize himself with the accounting policies which have been followed in the accounts under audit." Discuss
10. What are the fundamental accounting assumptions that underline the preparation of financial statements ?

11. Do you think that disclosure of accounting policies adopted in the presentation of financial statements enhances the intelligibility of such statements.
12. "The concept of materiality is fundamental to the process of recognition, aggregation, classification and presentation of accounting information". Discuss.
13. (a) What is an 'Audit Evidence'?
    (b) Why does an Auditor need evidence?
    (c) What are the factors which influence the auditors' judgment as to what is an appropriate audit evidence?
    (d) Discuss the principles which are useful in assessing the reliability of audit evidence.
    (e) Mention the main methods of obtaining audit evidence.
14. 'Audit evidence is one of the basic principles governing an audit'. Discuss and give the methods of obtaining audit evidence.

Multiple Choice Questions

1. Of the following , which is the best persuasive type of audit evidence ?
   (a) Bank statements obtained from the client
   (b) Documents obtained by auditor from third parties directly
   (c) Canbon copies of sales invoices inspected by the auditor
   (d) Computation made by the auditor
2. Which of the following statements is, generally, correct about the reliability of audit evidence ?
   (a) To be reliable, evidence should be conclusive rather than persuasive
   (b) Effective internal control system provides reliable audit evidence
   (c) Evidence obtained from outside sources routed through the client
   (d) All are correct
3. In an audit of financial statements, substantive tests are audit procedures that —
   (a) may be eliminated for an account balance under certain conditions
   (b) are designed to discover significant subsequent events
   (c) will increase proportionately when the auditor decreases the assessed level of control risk
   (d) may be test of transactions, test of balances and analytical procedures

4. The nature, timing and extent of substantive procedures is related to assessed level of —
   (a) control risk
   (b) randomly
   (c) disproportionately
   (d) directly inversely
5. Which of the following factors is most important in determining the appropriations of audit evidence ?
   (a) The reliability of audit evidence and its relevance in meeting the audit objective
   (b) The objectivity and integrity of the auditor
   (c) The quality of audit evidence
   (d) The independence of the source of evidence
6. When is evidential matter, generally, considered sufficient ?
   (a) When it constitutes entire population
   (b) When it is enough to provide a basis for giving reasonable assurance regarding truthfulness and fairness of financial statements.
   (c) When it is objective and relevant
   (d) When auditor Collects and evaluates it independently.
7. Which of the following is not a corroborative evidence ?
   (a) Minutes of meetings
   (b) Confirmations from debtors
   (c) Information gathered by auditor through observation
   (d) Worksheet supporting consolidated financial statements.
8. Which of the following statements is not true with respect to management representations obtained as per SA 580 ?
   (a) Authenticate copy of relevant minutes of meetings may be regarded as management representation.
   (b) It should always be in working
   (c) It may be dated prior to the report date
   (d) It should be addressed to the auditor

9. Analytical procedures issued in the planning stage of an audit, generally —
   (a) helps to determine the nature, timing and extent of other audit procedures
   (b) directs attention to potential risk areas
   (c) indicates important aspects of business
   (d) all are above.
10. Which of the following statements is most closely associated with analytical procedure applied at substantive stage ?
   (a) It helps to study relationships among balance sheet accounts.
   (b) it helps to discover material misstatements in the financial statements.
   (c) it helps to identify possible oversights.
   (d) it helps to accumulate evidence supporting the validity of a specific account balance.
11. For all audits of financial statements made in accordance with AAS-14, The use of analytical procedures is at the discretion of the auditor in which stage ?
   (a) Substantive testing
   (b) Planning stage
   (c) Overall review stage
   (d) All of the above.
12. The basic assumption underlying the use of analytical procedures is —
   (a) it helps the auditor to study relationship among elements of financial information
   (b) relationship among data exist and continue in the absence of known conditions to the contrary
   (c) analytical procedures will not be able to detect unusual relationships.
   (d) none of the above.
13. What are analytical procedures ?
   (a) Substantive tests designed to assess control risk
   (b) Substantive tests designed to evaluate the validity of management's representation letter
   (c) Substantive tests designed to study relationships between financial and non-financial information
   (d) All of the above.

14. "Audit Evidence" states the —
    (a) involvement of the accountant
    (b) credibility of the company
    (c) trust worthiness of the management
    (d) reliability of audit evidence influenced by its source and nature
15. Which of the following is not an analytical procedure ?
    (a) Tracing of purchases recurred in the purchase book to purchase invoices.
    (b) Comparing aggregate wages paid to number of employees
    (c) Comparing the actual costs with standard costs
    (d) All of them are analytical procedure
16. When applying analytical procedures, an auditor could develop an independent estimate of an account balance to compare it to --
    (a) Client's unedited account balance
    (b) Client's unedited account balance adjusted for trends in the industry
    (c) Prior year audited balance
    (d) Prior year audited balance adjusted for trends in the industry
17. What is the primary objective of analytical procedures used in the overall review stages of an audit ?
    (a) To help to corroborate the conclusions drawn from individual components of financial statements
    (b) To reduce specific detection risk
    (c) To direct attention to potential risk areas
    (d) To satisfy doubts when questions arise about a client's ability to continue in existence
18. The main advantage of using statistical sampling techniques is that such techniques —
    (a) Mathematically measure risk
    (b) Eliminate the need for judgmental sampling
    (c) Defines the values of tolerable error.
    (d) All of them

19. What would most appropriately describe the risk of incorrect rejection in terms of substantive testing ?
    (a) The auditor concludes balance is materially correct when in actual fact it is not
    (b) The auditor concludes that the balance is materially misstated when in actual fact it is not
    (c) The auditor has rejected an item for sample which was material
    (d) None of the above.
20. Which of the following affects audit effectiveness ?
    (a) Risk of over reliance
    (b) Risk of incorrect
    (c) Risk of incorrect acceptance
    (d) Both (a) and (c)
21. What would most effectively describe the risk of incorrect acceptance in terms of substantive audit testing ?
    (a) The auditor has ascertained that the balance is materially correct when in actual fact it is not
    (b) The auditor concludes that the balance is materially misstated when in actual fact it is not
    (c) The auditor has rejected an item from sample which was not supported by documentary evidence
    (d) He applies random sampling on data which is inaccurate and inconsistent
22. Tests of control are not concerned with —
    (a) Existence of controls
    (b) Effectiveness of controls
    (c) Continuity of controls
    (d) Designing of controls
23. The sequence of steps in the auditor's consideration of internal control is as follows —
    (a) Obtain an understanding, design substantive tests, perform tests of control, make a preliminary assessment of control risk.
    (b) Design substantive tests, obtain an understanding, perform tests of control, make a preliminary assessment of control risk.

(c) Obtain an understanding, make a preliminary assessment of control risk, perform tests of control, design substantive procedures.

(d) Perform tests of control, obtain an understanding, make a preliminary assessment of control risk, design.

24. Which of the following is not an inherent limitation of internal control system?

(a) Management override

(b) Collusion among employees

(c) Inefficiency of internal auditor

(d) Abuse of authority

25. An auditor should study and evaluate internal controls to —

(a) determine whether assets are safeguarded

(b) Suggest improvements in internal control

(c) Plan audit procedures

(d) Express an opinion

26. XYZ Ltd. Conducts a quarterly review of operations. It discovers that unrest in a South East Asian country may affect the supply of raw materials to it in the next quarter. This is an example of —

(a) risk assessment

(b) control procedure

(c) supervision

(d) control environment

27. The primary purpose of performing tests of control is to provide reasonable assurance that —

(a) There are no material misstatements due to fraud or error in financial statements

(b) Accounting system is well documented

(c) Written evidence is there to support transactions

(d) If internal control is effective

28. If the auditor assesses control risk as high —
    (a) Document the conclusions
    (b) Document the reasons along with conclusions
    (c) Perform tests of control
    (d) Perform walk through tests
29. The overall attitude and awareness of an entity's board of directors concerning the importance of internal control is reflected in —
    (a) Accounting controls
    (b) Control environment
    (c) Control procedures
    (d) Supervision
30. Which of the following are included in test of control ?
    (a) Performance and observation
    (b) inquiry and analytical procedures
    (c) Comparison and confirmation
    (d) Inspection and verification
31. Control risk is assessed at --
    (a) Overall financial statement level
    (b) Fraud risk factor level
    (c) Financial statement assertion level
    (d) Control environment level

CHAPTER 3

PREPARATION FOR AN AUDIT

Learning Objectives

After studying this chapter, you will be able to -

- Understand the preparation for an audit such as, auditor's engagement, audit process, audit techniques, procedures and planning.
- Draft audit programme, audit working paper, quality control of audit work and the elements of statistical sampling.
- Distinguish between different kinds of audit risk.

In the earlier chapter we have discussed the basic concepts of audit and the nature of evidence that is available to the auditor. Now we concern ourselves with how an auditor is to proceed for collection of evidence. Here starts the process of actual auditing. For effective work one has to frame a proper scheme of work and determine the techniques that are needed for collection of purposeful evidence. The scheme of auditing process envisages the following :

1. Formulating audit programme on the basis of knowledge of client's business.
2. Determination of the extent of checking on the basis of compliance procedures.
3. Carrying out the steps in the procedure on the basis of programme and the extent of substantive checking that may be required.
4. Keeping a record of notes and inquiries and maintenance of working papers.
5. Formulation of opinion about financial statements and review with reference to accounting standards.
6. Issuance of the audit report.

3.1 AUDITOR'S ENGAGEMENT

Accountancy and auditing are pursuits of a noble profession, the conduct of its members is governed by a set of the rules. One of the rules forbids chartered accountants to solicit

clients. Clients must themselves find their auditors. A client is anybody or any entity which requires the service of a professional accountant for the audit of the accounts or for any other purpose. Clients may be individuals, partnership firms, companies, societies, clubs, trust, co-operative societies, government, etc.

Of these, the legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract. The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards. Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax-returns, checking of the sales tax-returns, etc. besides audit. There may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts, is also covered. It is, therefore, of the greatest importance, both for the auditor and client, that each party should be clear about the nature of the engagement: it must be reduced in writing and should exactly specify the scope of the work. The audit engagement letter is sent by the auditor to his client which documents the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. The ICAI has issued SA 210 on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

In the case of partnerships, a few more precautions are needed. The appointment of the auditor is normally governed by the partnership deed. The accountant, when he is approached for undertaking a professional assignment by a firm or a partner of a firm, should first get a clear idea of the nature of the service required and then ensure, with reference to the terms of partnership agreement that his appointment is valid. Above all, he should bear in mind that all partners jointly and severally are his clients, though he might have been appointed by only one of them if so, authorised under the partnership deed. He must see that the individual interests of the partners have not been adversely affected in any manner and the provisions of the partnership deed regarding accounting have been fully given effect to.

In case of a recurring audit, the auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:

- Any indication that the client misunderstands the objective and scope of the audit.
- Any revised or special terms of the engagement.
- A recent change in senior management, board of directors or ownership.
- A significant change in nature or size of the client's business.
- Legal requirements or pronouncements of the Institute of Chartered Accountants of India, or changes in the existing ones.

Acceptance of a Change in Engagement: An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

A request from the client for the auditor to change the engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit or related service originally requested or a restriction on the scope of the engagement, whether imposed by management or caused by circumstances. The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement, specially any legal or contractual implications.

If the auditor concludes that there is reasonable justification to change the engagement and if the audit work performed complied with the SAs applicable to the changed engagement, the report issued would be appropriate for the revised terms of engagement. In order to avoid confusion, the report would not include reference to:

(a) the original engagement; or

(b) any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.

3.2 AUDIT PROCESS

One must take care to ensure that nothing is missed in the process which needs to be followed to achieve the audit objective. The following audit process in that order may be taken as a specimen:

(a) Formulating audit plan and laying down broad framework for conducting the work and method to ensure control over the quality of work.

(b) Examination and evaluation of the nature, extent and efficacy of the system of internal control. The nature, extent and timing of substantive procedures, would depend upon the extent of satisfaction an auditor obtains after evaluating the internal control system. The determination of extent of test checking would also depend upon the same.

(c) Ascertaining the arithmetical accuracy of the books of account by checking posting, casting, crass-casting, carry forwards, opening and closing balances, etc.

(d) Examining the documentary evidence (both internal and external) and the authority in support of the transaction, i.e. vouching:

(e) Checking the validity of transactions with reference to :

  (i) provisions affecting the accounts and audit in any Act or Rules;

  (ii) rules and regulations governing the constitution and management of the organisation i.e., the memorandum and articles of association in the case of a company, partnership deed in the case of a firm, trust deed in the case of a trust and bye-laws in the case of a co-operative society;

  (iii) minute books for appropriate sanction of the transactions by competent authority;

  (iv) other legal documents such as the prospectus, returns submitted to legal authorities, contracts and agreements *e.g.*, vendors' agreement, lease agreement, selling agency agreement, collaboration agreements, etc; and

  (v) well recognised accounting principles and practices *e.g.*, distinction between capital and revenue, accrual system of accounting, valuation principles, etc.,

(f) Ensuring that there is adequate disclosure of information and, in particular, the annual accounts are prepared in such a manner as to convey the real picture about the assets and liabilities and of the operating result (profit or loss) of the organisation. For this purpose, the auditor must conform to the prescribed legal requirement, if any, as to the form of accounts and have due regard to the best current accounting practice. Reference to Schedule VI in case of companies and compliance with accounting standards will have to be seen.

(g) Verification of existence, ownership, title and value of the assets and determination of the extent and nature of liabilities.

(h) Scrutiny of the accounts to establish reasonableness, consistency and compliance with the legal requirements.

(i) Application of various overall checks in order to test the overall reliability of the accounting records and the statements and to see whether the results of overall checks corroborate the findings already made.

(j) Determination of the significant accounting ratios and subjecting the accounts to ratio analysis to locate the areas showing departure from the expected state of affairs.

3.3 AUDIT TECHNIQUES

For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following :

1. Posting checking
2. Casting checking
3. Physical examination and count
4. Confirmation
5. Inquiry
6. Year-end scrutiny
7. Re-computation
8. Tracing in subsequent period
9. Bank Reconciliation

The two terms, procedure and techniques, are often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve techniques of inspection and checking computation of documentary evidence. As per SA-500 on Audit Evidence, basically audit procedures are broadly of two types viz. compliance procedures and tests of detail. Test of details are further comprised of substantive audit procedures and analytical review procedures. Vouching is a substantive audit procedure which involves audit techniques like casting,

cross-casting, checking of posting, etc. On the other hand, verification of assets and liabilities is a substantive audit procedure which involves application of audit techniques like physical examination, confirmation from third parties, etc.

3.4 AUDIT PROCEDURE

Selection of the appropriate audit procedure is again a matter of experience and judgment. Take extreme example of contingent liability in respect of pending suits : no entry or other records for this would be available to the auditor; verification of the estimate of the liability would become difficult for lack of basis. In such cases it would be more reasonable for the auditor to get the estimate confirmed by the solicitors of the company. In addition, he should examine the correspondence pertaining to the case and should discuss the matter with the company's officials. If the company was involved in a similar suit in the past, by going through the records thereof; the auditor would be able to pull out relevant considerations for estimating the liability. In any case the auditor is not precluded from making his own estimate on the basis of similar cases reported in the law journals.

The normal procedure for verification of cash balance is counting but this is not practicable in respect of the cash-in-transit. The auditor has to think in advance about the possibilities of departure from the normal procedure and the areas likely to be affected thereby. The procedure should provide for such situations in the programme.

It has been emphasised earlier that all available evidence should be used by the auditor but it is not intended to stretch it too far. Sometimes evidence collection becomes costly both in terms of money and time involved. If you are checking the cost of a building constructed by the client in addition to having recourse to all internal evidence, you may have the temptation of getting an independent valuation certificate by a professional valuer. This would be an unwise course in the absence of any suspicious circumstances- it would cost the company a lot of money for procuring that evidence for the satisfaction of the auditor; it may also give rise to an unwarranted feeling suspicion about the *bonafide* of the management, though there was no evidence available with the auditor to suggest it. The auditor must be cautious and reasonable in his attitude. If, however, the situation was otherwise, *i.e.,* the evidence normally made available to the auditor failed to provide him with satisfactory evidence about the cost incurred, it may be absolutely necessary for him to insist on an independent valuation.

While collecting audit evidence through an audit procedure, the auditor collects the same by employing different techniques. In order to verify a particular item in financial statements, say, cash, he may have to collect audit evidence from different sources. For

instance, in case of cash at bank, reference may be made to bank column in cash book, reference to bank reconciliation statement followed by examination of bank statement/bank pass book. Further, the auditor may like to obtain confirmation from the client's asset. During all this process, the auditor would have to see that audit evidence obtained from different sources does not contradict each other and the cost of obtaining more and more audit evidence is justified by the benefit flowing from obtaining such evidence.

Possibility of fraud and error is ruled out while framing the audit programme. The auditor should prescribe procedures and techniques keeping this possibility in view. If he undertakes a review and testing of internal controls and checks before or while drawing up the programme, he would reasonably be in a position to focus his attention on the matters where this possibility is rather great. The consideration of the auditor should be specifically directed to provide for the discovery of serious errors and frauds, the potential of which is great. The possibility of other errors which are generally not of great consequence can be left open to be observed and discovered in the course of normal evidence collection process.

Co-ordination of the procedures : Knowledge about accounting may be conveniently used in assembling the procedures in the most rational and natural manner. Fixed assets, like plant and machinery or buildings are directly linked with charges for repairs, maintenance and depreciation; purchase is linked with inward freight and sales with outward freight, sales tax and excise duty; earnings from investments bear a relationship with the investments. Hence, in assembling the procedures and methods, if the related items are grouped together, the programme becomes cohesive, comprehensive, purposeful and easy to coordinate; the work can also he conveniently distributed amongst assistants on the basis of the groupings so that, say the assistant assigned the work in connection with plant and machinery would be responsible for carrying out also the related work, *e.g.,* repairs and depreciation. This would help easy flow of work with the least possibility of any information gap to the assistant concerned.

3.5 AUDIT PLANNING

As per Auditing and Assurance Standard 1, "Basic Principles Governing an Audit", Audit Planning is one of the basic principles. Accordingly, it states :

"The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

Plans should be made to cover, among other things :

(a) acquiring knowledge of the client's accounting systems, policies and internal control procedures;

(b) establishing the expected degree of reliance to be placed on internal control;

(c) determining and programming the nature, timing, and extent of the audit procedures to be performed; and

(d) coordinating the work to be performed.

Plans should be further developed and revised as necessary during the course of the audit."

SA-300 further expounds this principle. According to it, planning should be continuous throughout the engagement and involves :

- developing an overall plan for the expected scope and conduct of the audit; and
- developing an audit programme showing the nature, timing and extent of audit procedures.

Changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan of and the audit programme. The reasons for significant changes may be documented.

Objectives of Planning : Adequate audit planning helps to :

- ensure that appropriate attention is devoted to important areas of the audit;
- ensure that potential problems are promptly identified;
- ensure that the work is completed expeditiously;
- utilise the assistants properly; and
- co-ordinate the work done by other auditors and experts.

In planning his audit, the auditor will consider factors such as complexity of the audit, the environment in which the entity operates, his previous experience with the client and knowledge of the client's business.

The auditor may wish to discuss elements of his overall plan and certain audit procedures with the client to improve the efficiency of the audit and to coordinate audit procedures with work of the client's personnel. The overall audit plan and the audit programme, however, remain the auditor's responsibility.

3.5.1 Knowledge of the Client's Business

It is one of the important principles in developing an overall audit plan. Infact without adequate knowledge of client's business, a proper audit is not possible. SA-310 on "Knowledge of the Business" deals in detail about the significance of such knowledge on the part of the auditor.

The auditor needs to obtain a level of knowledge of the client's business that will enable him to identify the events, transactions and practices that, in his judgment, may have significant effect on the financial information. Among other things, the auditor can obtain such knowledge from :

- The client's annual reports to shareholders.
- Minutes of meetings of shareholders, board of directors and important committees.
- Internal financial management reports for current and previous periods, including budgets, if any.
- The previous year's audit working papers, and other relevant files.
- Firm personnel responsible for non-audit services to the client who may be able to provide information on matters that may affect the audit.
- Discussions with client.
- The client's policy and procedures manual.
- Relevant publications of the Institute of Chartered Accountants of India and other professional bodies, industry publications, trade journals, magazines, newspapers or text books.
- Consideration of the state of the economy and its effect on the client's business.
- Visits to the client's premises and plant facilities.

With respect to the previous year's audit working papers and other relevant files, the auditor should pay particular attention to matters that requires special consideration and decide whether they might affect the work to be done in the current year.

Discussions with the client might include such subjects as :

- Changes in management, organisational structure and activities of the client.
- Current Government legislation, rules, regulations and directives affecting the client.

- Current business developments affecting the client.
- Current or impending financial difficulties or accounting problems.
- Existence of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- New or closed premises and plant facilities.
- Recent or impending changes in technology, type of products or services and production or distribution methods.
- Significant matters arising from previous year's financial statements, audit report and management letters, if any.
- Changes in the accounting practices and procedures and in the system of internal control.
- Scope and timing of the examination.
- Assistance of client personnel in data preparation.
- Relevance of any work to be carried out by the client's internal auditors.

In addition to the importance of knowledge of the client's business in establishing the overall audit plan, such knowledge helps the auditor to identify areas of special audit consideration, to evaluate the reasonableness both of accounting estimates and management representations, and to make judgments regarding the appropriateness of accounting policies and disclosures.

3.5.2 Development of an Overall Plan

The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit :

- The terms of his engagement and any statutory responsibilities.
- The nature and timing of reports or other communication.
- The applicable legal or statutory requirements.
- The accounting policies adopted by the client and changes in those policies.
- The effect of new accounting or auditing pronouncements on the audit.
- The identification of significant audit areas.
- The setting of materiality levels for audit purposes.

- Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
- The degree of reliance he expects to be able to place on accounting system and internal control.
- Possible rotation of emphasis on specific audit areas.
- The nature and extent of audit evidence to be obtained.
- The work of internal auditors and the extent of their involvement, if any, in the audit.
- The involvement of other auditors in the audit of subsidiaries or branches of the client.
- The involvement of experts.
- The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
- Establishing and coordinating staffing requirements.

The auditor should document his overall plan. The form and extent of the documentation will vary depending on the size and complexity of the audit. A time budget, in which hours are budgeted for the various audit areas or procedures, can be an effective planning tool.

3.5.3 Developing the Audit Programme

The auditor should prepare a written audit programme setting forth the procedures that are needed to implement the audit plan. The programme may also contain the audit objectives for each area and should have sufficient details to serve as a set of instructions to the assistants involved in the audit and as a means to control the proper execution of the work.

In preparing the audit programme, the auditor, having an understanding of the accounting system and related internal controls, may wish to rely on certain internal controls in determining the nature, timing and extent of required auditing procedures. The auditor may conclude that relying on certain internal controls is an effective and efficient way to conduct his audit. However, the auditor may decide not to rely on internal controls when there are other more efficient ways of obtaining sufficient appropriate audit evidence. The auditor should also consider the timing of the procedures, the coordination of any assistance expected from the client, the availability of assistants, and the involvement of other auditors or experts.

The auditor normally has flexibility in deciding when to perform audit procedures. However, in some cases, the auditor may have no discretion as to timing, for example, when observing the taking of inventories by client personnel or verifying the securities and cash balances at the year-end.

The audit planning ideally commences at the conclusion of the previous year's audit, and along with the related programme, it should be reconsidered for modification as the audit progresses. Such consideration is based on the auditor's review of the internal control, his preliminary evaluation thereof, and the results of his compliance and substantive procedures.

3.6 AUDIT PROGRAMME

It is desirable that in respect of each audit and more particularly for bigger audits an audit programme should be drawn up. Audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client. In other words, an audit programme is a detailed plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives. Businesses vary in nature, size and composition; work which is suitable to one business may not be suitable to others; efficiency and operation of internal controls and the exact nature of the service to be rendered by the auditor are the other factors that vary from assignment to assignment. Because of such variations, evolving one audit programme applicable to all business under all circumstances is not practicable. However it becomes a necessity to specify in detail in the audit programme the nature of work to be done so that no time will be wasted on matters not pertinent to the engagement and any special matter or any specific situation can be taken care of.

To start with, an auditor having regard to the nature, size and composition of the business and the dependability of the internal control and the given scope of work, should frame a programme which should aim at providing for a minimum essential work which may be termed as a standard programme. As experience is gained by actually carrying out the work, the programme may be altered to take care of situations which were left out originally, but are found relevant for the particular concern. Similarly, if any work originally provided for proves beyond doubt to be unnecessary or irrelevant, it may be dropped. The assistant engaged in the job should be encouraged to keep an open mind beyond the

programme given to him. He should be instructed to note and report significant matters coming to his notice, to his seniors or to the partners or proprietor of the firm engaged for doing the audit.

There should be periodic review of the audit programme to assess whether the same continues to be adequate for obtaining requisite knowledge and evidence about the transactions. Unless this is done, any change in the business policy of the client may not be adequately known, and consequently, audit work may be carried on, on the basis of an obsolete programme and, for this negligence, the whole audit may be held as negligently conducted and the auditor may have to face legal consequences. For example, if the audit programme for the audit of a branch of a financing house, drawn up a number of years ago, fails to take into consideration that the previous policy of financing of a vehicle has been changed to financing of real estate acquisition, the whole audit conducted thereunder would be entirely misdirected and may even result into nothing more than a farce. [*Pacific Acceptance Corporation Ltd.* v. *Forsyth and Others*.]

The utility of the audit programme can be retained and enhanced only by keeping the programme as also the client's operations and internal control under periodic review so that inadequacies or redundancies of the programme may be removed. However, as a basic feature, audit programme not only lists the tasks to be carried out but also contains a few relevant instructions, like the extent of checking, the sampling plan, etc. So long as the programme is not officially changed by the principal, every assistant deputed on the job should unfailingly carry out the detailed work according to the instructions governing the work. Many persons believe that this brings an element of rigidity in the audit programme. This is not true provided the periodic review mentioned earlier is undertaken to keep the programme as up-to-date as possible and by encouraging the assistants on the job to observe all salient features of the various accounting functions of the client.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statements. For the purpose of programme construction, the following points should be kept in view :

1. Stay within the scope and limitation of the assignment.
2. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
3. Apply only these steps and procedures which are useful in accomplishing the verification purpose in the specific situation.

4. Consider all possibilities of error.

5. Co-ordinate the procedures to be applied to related items.

Amplification is not necessary of the above points except the one under evidence : that is the very basis for formulation of opinion and an audit programme is designed to provide for that by prescribing procedures and techniques. What is best evidence for testing the accuracy of any assertion is a matter of expert knowledge and evidence. This is the primary task before the auditor when he draws up the audit programme. Transactions are varied in nature and impact; procedures to be prescribed depend on prior knowledge of what evidence is reasonably available in respect of each transaction.

By evidence we mean the material, documentary or otherwise, available to prove or disprove the assertions made in the statement of accounts through the entries in the books of account. For example sales is evidenced by :

(i) invoices raised by the client;

(ii) price list;

(iii) forwarding notes to client;

(iv) stock-issue records;

(v) sales managers' advice to the stock section;

(vi) acknowledgements of the receipt of goods by the customers, and

(vii) collection of money against sales by the client.

In most of the assertions much of the evidence be drawn and each one should be considered and weighed to ascertain its weight to prove or disprove the assertion. In this process, an auditor would be in a position to identify the evidence that brings the highest satisfaction to him about the appropriateness or otherwise of the assertion.

You may recall from chapter 2 on basic concepts in auditing that an auditor picks up evidence from a variety of fields and it is generally of the following broad types :

(a) Documentary examination

(b) Physical examination

(c) Statements and explanation of management, officials and employees

(d) Statements and explanations of third parties

(e) Arithmetical calculations by the auditor

(f) State of internal controls and internal checks

(g) Inter-relationship of the various accounting data

(h) Subsidiary and memorandum records

(i) Minutes

(j) Subsequent action by the client and by others.

By "good evidence" we mean a highly satisfactory evidence available without any special effort or cost. For cash in hand the best evidence is 'count'; in respect of investment pledged with a bank, the banker's certificate. For verifying assertions about book debts, the client's ledger invoices, debit notes, credit notes, monthly accounts statement sent to the customers are all evidence : some of these are corroborative, other being complementary. In addition, balance confirmation procedure is often resorted to, to obtain greater satisfaction about the reliability of the assertion. The auditor, however, has to place appropriate weight on each piece of evidence and accordingly should prescribe the priority of verification. It is true that in all cases one procedure may not bring the highest satisfaction and it may be dangerous for the auditor to ignore any evidence that is available. By the word "available" we do not mean that the evidence available with the client is the only available evidence. The auditor should know what normally should be available in the context of the transaction having regard to the circumstances and usage. For testing the authenticity of the client as regards amount lying with bank, the auditor adopts the following procedure :

1. Examination of the counterfoils of cheques and paying-in-slips and comparing them with the entries in the concerned ledger account of the client.
2. Checking the castings, carry over and balances of the ledger account.
3. Comparison of the entries in the ledger with the bank statement (this is the reproduction of the ledger account maintained by the bank for recording the transactions with the client).
4. Examination of the bank reconciliation statement to know the items that explain the difference, if any, between the balance shown by client's ledger and the bank statement.
5. Scrutiny of the subsequent period's bank statement to ensure that items entering for reconciliation have been duly entered by the bank on clearance or presentation.
6. Verification of official confirmation of the balance by the bank.

If you analyse these procedures, you will see that each provides the auditor with some evidence which by itself is not adequate even if the result is satisfactory. The first one proves that the entries conform to the underlying records, but the *prima facie* authenticity of the underlying record is corroborated by a checking of the bank statement. The second

provides evidence of the arithmetical accuracy. Procedure under step four, screens the items of difference between the two records and the *bonafide* of that statement is proved by step five. Sixth and the last step is most significant because the reliability of the bank statement is much enhanced by confirmation of the balance on a specified date made by a responsible official of the bank. But all these cannot give the auditor a degree of confidence or conclusiveness because he has no access to the bank's books and records. Therefore, he must be contended with the best available evidence to arrive at a reasonable opinion.

At times, the available evidence on a single assertion may be found to be contradictory. For example, sales in quantity and value, as evidenced by some of the procedures enumerated above, may not be corroborated by a quantitative analysis of the opening stock, production, sales and closing stock. In such a situation, it would be the duty of the auditor to call for the explanation of the management before he accepts or rejects any of the contradictory evidence for the purpose of formulation of his opinion on the particular matter. Only by properly considering and evaluating the explanation of the management, the auditor is in such a situation as would enable him to accept or reject any of the evidence.

3.6.1 Advantages and Disadvantages of the use of an Audit Programme

(a) It provides the assistant carrying out the audit with total and clear set of instructions of the work generally to be done.

(b) It is essential, particularly for major audits, to provide a total perspective of the work to be performed.

(c) Selection of assistants for the jobs on the basis of capability becomes easier when the work is rationally planned, defined and segregated.

(d) Without a written and pre-determined programme, work is necessarily to be carried out on the basis of some 'mental' plan. In such a situation there is always a danger of ignoring or overlooking certain books and records. Under a properly framed programme, the danger is significantly less and the audit can proceed systematically.

(e) The assistants, by putting their signature on programme, accept the responsibility for the work carried out by them individually and, if necessary, the work done may be traced back to the assistant.

(f) The principal can control the progress of the various audits in hand by examination of audit programmes initiated by the assistants deputed to the jobs for completed work.

(g) It serves as a guide for audits to be carried out in the succeeding year.

(h) A properly drawn up audit programme serves as evidence in the event of any charge of negligence being brought against the auditor. It may be of considerable value in establishing that he exercised reasonable skill and care that was expected of professional auditor.

Some disadvantages are also there in the use of audit programmes but most of these can be removed by taking some steps which otherwise also contribute to the making of a good audit. The disadvantages are :

(a) The work may become mechanical and particular parts of the programme may be carried out without any understanding of the object of such parts in the whole audit scheme.

(b) The programme often tends to become rigid and inflexible following set grooves; the business may change in its operation of conduct, but the old programme may still be carried on. Changes in staff or internal control may render precaution necessary at points different from those originally decided upon.

(c) Inefficient assistants may take shelter behind the programme i.e. defend deficiencies in their work on the ground that no instruction in the matter is contained therein.

(d) A hard and fast audit programme may kill the initiative of efficient and enterprising assistants.

All these disadvantages may be eliminated by imaginative supervision of the work carried on by the assistants; the auditor must have a receptive attitude as regards the assistants; the assistants should be encouraged to observe matters objectively and bring significant matters to the notice of supervisor/principal.

3.7 METHODS OF WORK

In order than an audit may be carried out in a systematic and efficient manner, the following steps should be taken :

(1) Work must be carried on regularly and record kept of time of arrival/departure of the staff and also of the work done each day;

(2) As far as possible, a definite portion of the work should be completed each day so that loose ends are not left over for being tied up at a later date;

(3) Entries should be made in the audit note book and the audit programme initialled as a routine;

(4) Coloured pencils and different type of ticks must be employed to indicate the various audit processes which have been applied and their significance must not be disclosed to the client;

(5) All the vouchers after examination must be immediately cancelled with an audit stamp;

(6) Staff members should refrain from discussing the client's affairs amongst themselves and with outsiders.

3.8 CONTINUOUS AND FINAL AUDIT

Final or *Completed* or *Periodical Audit :* A final or completed audit is commonly understood to be an audit which does not begin until the books have closed at the end of the accounting period and thereafter is carried on continuously until completed. Whether an audit ought to be conducted continuously after the close of the financial year should be decided on a consideration of the size of the business and the extent of detailed checking required.

Advantages of such an audit are :

(i) Work can be carried on till the audit is over, thus, avoiding the necessity of having to return on separate occasions to complete the work.

(ii) The possibility of figures being altered after work has been done is also avoided.

(iii) Allocation of work for staff also becomes easier.

Disadvantages of final or completed audit include may be mainly on account of delay which may occur after the end of the financial period particularly if size of the business is large; accounting periods of several clients may end on the same date, and thus difficulties may be experienced in allocating audit staff.

Continuous audit : A continuous audit is one in which the auditor's staff is engaged continuously in checking the accounts of the client the whole year round or when for this purpose the staff attends at intervals, fixed or otherwise, during the currency of the financial period. Strictly speaking, when auditor's staff attends the audit work at fixed intervals it may be strictly called interim audit. This is when an audit is conducted up to a particular date within the accounting period. The auditor may attend to audit the figures for a month or for a quarter, as the work may require. It would differ distinctly from the final audit in the extent of the work carried out; verification of assets, for example would be left until the final audit. In case of continuous audit, the work is conducted throughout the course of the financial year but is not taken to a specific accounting period, as is an interim audit. It might be that during the course of the continuous work interim figures are being audited, but the significant factor here is that the auditor will be engaged continuously on the audit throughout the financial period. Staff may be in residence throughout the period or may come and go at irregular intervals, but most of the time, the

audit staff is present at the location. Thus, in case of continuous audit, the audit staff is present as the client's premises almost during the entire accounting period.

Advantages :

(1) Errors are discovered earlier with the result that there is adequate time for making the necessary rectification.

(2) Because of the frequent attendance of the auditor, the opportunities of committing frauds are reduced.

(3) Fraud, if perpetrated, is detected sooner with the result that size of the fraud is limited and also the chances of recovering the amount lost are improved.

(4) The attendance of the audit staff acts a moral check on the client's staff.

(5) The client's accounts are always kept up-to-date.

(6) Since audit can be carried on throughout the year, there is more time for detailed checking of the accounts when the audit is taken up at the close of the year.

(7) If the audit of routine transactions is completed before the close of the year, the final accounts can be prepared and reported upon much earlier.

(8) If the auditor carries on a continuous audit, he remains constantly in touch with the client's affairs thereby able to carry out his duties efficiently.

(9) In the case of continuous audit, the work of the auditor is greatly facilitated since he is in a better position to plan out his engagements and take up the job at his convenience, avoiding the pressure at the close of the financial year when most of the business firms usually close their accounts.

Disadvantages :

(1) There is a danger that the records of transactions after they have been audited may be altered either innocently or fraudulently.

(2) The examination of an item left incomplete on a visit for being undertaking on the next visit may be overlooked.

(3) A continuous audit may involve good deal of waste of time and effort if the size of the concern is small.

The disadvantages of a continuous audit can be avoided if the following precautions are taken:

(1) During the course of each visit, work should be completed upto a definite stage so as to avoid loose ends.

(2) At the end of each visit, important balances should be noted down and the same should be compared at the time of the next visit.

(3) The visits should be at irregular intervals of time so that the client's staff may not in advance know the exact date when the audit would be resumed and thus may be able to prepare themselves in advance for the same.

(4) The nominal accounts should be checked only at the time of final closing.

(5) The client's staff should be instructed not to alter or correct audited figures. The auditor should also device a special form of ticks for being placed against figures which have been altered and neither its purpose nor significance should be disclosed to the client's staff.

Thus, it is clear from the above that final or completed audit approach is advisable in case size of the entity is very small. On the other hand, continuous audit may be followed only in case size of the entity is very large and system of internal control is weak since the great disadvantage of continuous audit is that the cost would be very high and continuous presence of audit staff may impair auditor's independence. The interim audit conducted on quarterly or half-yearly basis is the most practicable solution.

3.9 AUDIT PLANNING AND MATERIALITY

As stated in the previous chapter, materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not. SA 320 on "Audit Materiality" requires that an auditor should consider materiality and its relationship with audit risk while conducting an audit. When planning the audit, the auditor considers what would make the financial information materially mis-stated. The auditor's preliminary assessment of materiality related to specific account balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. Students may note that the auditor's assessment of materiality and audit risk may be different at the time of initially planning of the audit as against at the time of evaluating the results of audit procedures.

3.10 THE OVERALL AUDIT APPROACH

The auditor must gather sufficient competent evidential matter as a basis for forming his opinion on :

(a) the truth and fairness of the accounts and also their compliance with the provisions of the related laws, rules and regulations;

(b) the proper keeping of the accounting records, and other records and related registers of the client.

These broad objectives may be amplified as follows :

To determine whether :

(1) all assets and liabilities are properly stated and classified on a basis consistent with that of the previous year;

(2) proper disclosure is made of securities for liabilities and of assets charged or secured;

(3) the client has complied with the provisions of the applicable laws and documents created under them, loan agreements and other documents to which he is a party;

(4) income and expenses are properly classified and disclosed and are properly matched. They relate to the period in which they are reported and have been determined on a basis consistent with that of the previous year;

(5) all contingencies and commitments are properly disclosed;

(6) no material omissions have been made in the financial statements;

(7) no material error or inaccuracy in reporting or disclosing income, expenses, assets and liabilities has been created in the financial statements;

(8) the books and records have been properly kept in accordance with the requirements of the client.

The expression of opinion on the overall balance sheet and profit and loss account involves initially forming an opinion on each of the balance sheet or profit and loss items; it is necessary first to decide what are the essential conditions or pre-requisites for each balance sheet or profit and loss account item in order to give a true and fair view of the particular assets or liabilities or item of income or expense being represented. These conditions are well established and may be illustrated by reference to the areas of sundry debtors and sales revenues.

Sundry Debtors : The audit of sundry debtors should be sufficiently comprehensive to enable the auditor to form an opinion as to whether :

(1) The amounts shown represent *bonafide* receivables of the company.

(2) The receivables are properly classified.

(3) Adequate provisions have been made for uncollectible receivables and for discounts and freight allowable, returns adjustments, etc.

(4) Any receivables have been pledged, discounted, assigned or sold, and if so whether they are properly disclosed.

Sales Revenues : Specific objectives in the audit of sales revenues are to determine whether:

(1) Sales accounting procedures are operating effectively to produce reliable sales revenue figures for the period.

(2) Sales revenues have been recorded in the proper accounting period and are not overstated through improper credits for fictitious sales of goods neither supplied nor set aside. Conversely, whether sales or other revenues are understated through deferring the recording thereof to subsequent periods or omitting to record sales despatched as sales.

(3) Allowance, returns and other sales deductions are fairly stated and properly treated in the financial statements and that adequate provisions have been made for any significant additional amount that may be anticipated to be paid but not yet finally settled.

(4) Non-operating revenues have been segregated from sales revenues and have been appropriately treated in the profit and loss statement.

3.11 AUDIT WORKING PAPERS

The audit working papers constitute the link between the auditor's report and the client's records. Documentation is one of the basic principles listed in SA 200. According to SA-230 (reproduced in Appendix I), documentation refers to working papers prepared or obtained by the auditor and retained by him in connection with performance of his audit. The objects of an auditor's working papers are to record and demonstrate the audit work from one year to another. Therefore, working papers should provide for :

(a) means of controlling current audit work;

(b) evidence of audit work performed;

(c) schedules supporting or additional item in the accounts; and

(d) information about the business being audited, including the recent history.

Working papers are varied in nature but the foundation of all working paper can be traced to :

(1) the basic constitutional documents like Memorandum and Articles of Association, Partnership Deed, Trust Deed, etc.;

(2) the contents of the minute books;

(3) the contents of the balance sheet and the profit and loss account; and

(4) the letter of engagement.

3.11.1 Form and Content of Working Papers

Working papers should record the audit plan, nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained. The form and content of working papers are affected by matters such as :

- Nature of the engagement.
- Form of the auditor's report.
- Nature and complexity of the client's business
- Nature and condition of the client's records and degree of reliance on internal controls.
- Need in particular circumstances for direction, supervision and review of work performed by assistants.

Working papers should be designed and properly organised to meet the circumstances of each audit and the auditor's needs in respect thereof. The standardisation of working papers (for example, checklists, specimen letters, standard organisation of working papers) improves the efficiency with which they are prepared and reviewed. It also facilitates the delegation of work while providing a means to control its quality. Working papers should be sufficiently complete and detailed for an auditor to obtain an overall understanding of the audit. The extent of the documentation is a matter of professional judgment since it is neither necessary nor practical that every observation, consideration or conclusion is documented by the auditor in his working papers.

All significant matters which require the exercise of judgment, together with the auditor's conclusion thereon, should be included in the working papers.

To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client. In such circumstances, the auditor

should satisfy himself that these working papers have been properly prepared. Examples of such working papers are detailed analysis of important revenue accounts, receivables etc.

In the case of recurring audits, some working paper files may be classified as permanent audit files which are updated currently with information of continuing importance to succeeding audit, as distinct from current audit files which contain information relating primarily to the audit of a single period.

A permanent audit file normally includes :

- Information concerning the legal and organisational structure of the entity. In the case of a company, this includes the Memorandum and Articles of Association. In the case of a statutory corporation, this includes the Act and Regulations under which the corporation functions.
- Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
- A record of the study and the evaluation of the internal controls related to the accounting system. This might be in the form of narrative descriptions, questionnaires or flow charts, or some combination thereof.
- Copies of audited financial statements for previous years.
- Analysis of significant ratios and trends.
- Copies of management letters issued by the auditor, if any.
- Record of communication with the retiring auditor, if any, before acceptance of the appointment as auditor.
- Notes regarding significant accounting policies.
- Significant audit observations of earlier years.

The current file normally includes :

- Correspondence relating to acceptance of annual reappointment.
- Extracts of important matters in the minutes of Board Meetings and General Meetings as relevant to audit.
- Evidence of the planning process of the audit and audit programme.
- Analysis of transactions and balances.

- A record of the nature, timing and extent of auditing procedures performed, and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- Copies of communication with other auditors, experts and other third parties.
- Letters of representation or confirmation received from the client.
- Conclusions reached by the auditor concerning significant aspects of the audit, including the manner in which exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial information being reported on and the related audit reports.

3.11.2 Audit Note Book

An audit note book is usually a bound book in which a large variety of matters observed during the course of audit are recorded. It is thus a part of the permanent record of the auditor available for reference later on, if required. The audit note book also provides a valuable help to the auditor in picking up the links of work when the concerned assistant is away or the work is stopped temporarily because in it are recorded along with observations, the various queries, explanations obtained and evidence seen, while queries remaining undisposed of would be noted for follow up. It is more satisfactory in some ways, however, to use loose sheets for entering queries and notes which, subsequently, on being punched, may be filed in a special query file maintained for each client or along with the clients' accounts and papers, separately for each year.

Significant matters observed during the course of audit, a record of which should be kept in the Audit Note Book :

(a) Audit queries not cleared immediately *e.g.* missing receipts, vouchers, etc.

(b) The mistakes or irregularities observed during the course of audit *e.g.* cases of failure to comply with the requirements of the Companies Act, 1956 or the provisions contained in the Memorandum or Articles; a change in the basis of valuation of finished stock and work-in-progress or in the computation of depreciation; failure to provide adequate depreciation, etc.

(c) Unsatisfactory book-keeping arrangements, costing method, internal or financial administration or organisation.

(d) Important information about the company which is not apparent from the accounts.

(e) Special points requiring consideration at the time of verification of final accounts.

(f) Important matters for future reference.

Specimen of entries in an Audit Note Book to indicate the manner in which entries in those books ought to be made :

Queries-Vouchers-Cash Book Payment

Voucher	*Account Debited*	*Rs.*	*Query*	*How disposed of*
38	Advertisement	1,600	Managing Director's sanction required	Sanction obtained
107	Rent	1,500	Rent, bill & receipt required	Receipt & bill obtained
306	Das & Co.	3,474	Receipt required	Party reminded
42	Machinery	1,49,160	Board's sanction required	Sanction obtained minute dated 10-1-99
89	Stores	7,403	Invoice required	Party reminded
128	Raw material	13,457	Rates for items (i) & (ii) are different from those on the purchase order	Items of the quality ordered not being available, a better quality was accepted under purchase officer's approval.

The making of intelligent enquiries on the accounts under audit is an important part of the work of an auditor. However, to guard against the client's staff being required to provide explanation and information which are unnecessary or which could be ascertained otherwise junior members of the audit staff should be allowed to raise audit queries only after obtaining the prior approval of the senior incharge. Nonetheless, the enthusiasm of an intelligent and energetic junior should not go unrewarded and, as such, the queries he wishes to raise and which are not pertinent or important should be discussed and explained to him.

The audit notes constitute important evidence of matters considered by the auditor during the course of the audit, some of which may not find a place in his report submitted to the shareholders or directors, for the reason that on the basis of an explanation given to him by the management, he, on being satisfied, decided to drop them. As such, audit notes can be an important defence for the auditor in the event of an action for negligence in the discharge of his duties being subsequently brought against him.

In the past, these have been used for successfully defending a legal action brought against an auditor alleging negligence in performance of his duties. For instance in the case of *City Equitable Fire Insurance Company Limited* the auditor was greatly assisted in his defence by the well maintained record of work that had been carried out by him in regard to the audit. The necessity of maintaining a systematic record of audit queries also was greatly emphasised by Lord Justice Williams while delivering the judgment in the case of London and General Bank.

Audit notes can also serve as a guide in framing audit programme in the future as they indicate the weaknesses in the system of the client which specially need to be watched.

Also, it is desirable that the audit notes, whether they are kept in a book or in loose sheets, should bear a reference to the particular item of work in the audit programme, and as far as practicable, all notes relating to the particular work in the programme should be kept together in the systematic order.

3.11.3 Ownership and Custody of Working Papers

Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. Audit working papers are the property of the auditor and he is entitled to retain them. (*Chantery Martin & Co.* v. *Martin*).

3.11.4 Importance of Working Papers

(i) It provides guidance to the audit staff with regard to the manner of checking the schedules.

(ii) The auditor is able to fix responsibility on the staff member who signs each schedule checked by him.

(iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.

(iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention.

Clarification On The Auditors' Rights Where Clients And Other Auditors Seek Access To Their Audit Working Papers

1. Auditing and Assurance Standard SA 200, "Basic Principles Governing an Audit", states in para 6: "The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to a third party without specific authority or unless there is a legal or professional duty to disclose". Auditing and Assurance Standard SA 230, "Documentation" (Paragraph 13), states: "Working papers are the property of the auditor. The auditor may, at his discretion, make portions of or extracts from his working papers available to his client. SA 230 further requires (paragraph 14), *inter alia*, that the "auditor should adopt reasonable procedures for custody and confidentiality of his working papers."

2. Part I of the Second Schedule to the Chartered Accountants Act, 1949, provides that "A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise than as required by any law for the time being in force."

3. Requests are sometime received by the members of the Institute, who have/had been performing the duties as the auditors of an enterprise, to provide access to their audit working papers. The requests may be made by the clients or other auditors of the enterprise or its related enterprise such as a parent enterprise.

4. It is hereby clarified that except to the extent stated in para 5 below, an auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprise such as a parent or a subsidiary, access to his audit working papers. The main auditors of an enterprise do not have right of access to the audit working papers of the branch auditors. In the case of a company, the statutory auditor has to consider the report of the branch auditor and has a right to seek clarifications and/or to visit the branch if he deems it necessary to do so for the performance of the duties as auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of the other auditor. For this purpose, the term 'auditor' includes 'internal auditor'.

5. As stated in para 4, the client does not have a right to access the working papers of the auditor. However, the auditor may, at his discretion, in cases considered appropriate by him, make portions of or extracts from his working papers available to the client.

3.12 QUALITY CONTROL FOR AUDIT WORK

An audit is a complex task involving number of people at different levels. As we observed in the preparation and development of audit programme, the auditor would naturally have

to depend upon number of technical experts as well. During the course of his work, the auditor is also likely to use the work performed by other auditors also. A lot of work is also delegated by him to his assistants SA 200, "Basic Principles Governing an Audit", the auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose. SA 220, "Quality Control for Audit Work" lays down standards on the quality control.

(a) policies and procedures of an audit firm regarding audit work generally; and

(b) procedures regarding the work delegated to assistants on an individual audit.

SA 220 suggests two fold approach to quality control, viz., first, at the firm level, and, secondly, at the individual audit level.

3.12.1 Firm Level

At the firm level, *SA 220* requires that the audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with Auditing and Assurance Standards (SAs). Compliance with all SAs would necessitate that the quality control policies to be adopted by a firm would incorporate that standards of professional requirements, technical competence, training, proficiency, etc. are observed at the firm level. The objective of the quality control policies to be adopted by an audit firm will ordinarily incorporate the following:

(a) *Professional Requirements*: Personnel in the firm are to adhere to the principles of Independence, Integrity, Objectivity, Confidentiality and Professional Behavior.

(b) *Skills and Competence*: The firm is to be staffed by personnel who have attained and maintain the Technical Standards and Professional Competence required to enable them to fulfil their responsibilities with Due Care.

(c) *Assignment*: Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

(d) *Delegation*: There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

(e) *Consultation*: Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.

(f) *Acceptance and Retention of Clients*: An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to

accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.

(g) *Monitoring*: The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

3.12.2 Individual Audit Level

At the individual audit level, however, it shall be absolutely necessary that the work delegated to assistants is directed, supervised and reviewed in a proper manner.

Direction: Direction involves informing assistants of their responsibilities and the objectives of the procedures they are to perform. It also involves informing them of matters, such as the nature of the entity's business and possible accounting or auditing problems that may affect the nature, timing and extent of audit procedures with which they are involved. The audit programme is an important tool for the communication of audit directions. Time budgets and the overall audit plan are also helpful in communicating audit directions.

Supervision: Supervision is closely related to both direction and review and may involve elements of both. Personnel carrying out supervisory responsibilities perform the following functions during the audit:

(a) monitor the progress of the audit to consider whether:

  (i) assistants have the necessary skills and competence to carry out their assigned tasks;

  (ii) assistants understand the audit directions; and

  (iii) the work is being carried out in accordance with the overall audit plan and the audit programme.

(b) become informed of and address significant accounting and auditing questions raised during the audit, by assessing their significance and modifying the overall audit plan and the audit programme as appropriate; and

(c) resolve any difference of professional judgement between personnel and consider the level of consultation that is appropriate.

Responsibilities would include to monitor the progress of audit, consider significant accounting and auditing question and resolve any difference of professional judgement as well.

Review: The work performed by each assistant would require to be reviewed by a personnel of at least general competence.

3.13 ELEMENTS OF STATISTICAL SAMPLING

No conscious effort in human society is divested of economic considerations and auditing is no exception. There is a growing realisation that the traditional approach to audit is economically wasteful because all efforts are directed to check all transactions without exception. This invariably leads to more emphasis on routine checking, which often is not necessary in view of the time and the cost involved. With the shift in favour of formal internal controls in the management of affairs of organisations, the possibilities of routine errors and frauds have greatly diminished and auditors often find extensive routine checking as nothing more than a ritual because it seldom reveals anything material. Now the approach to audit and the extent of checking are undergoing a progressive change in favour of more attention of the questions of principles and controls with a curtailment of non-consequential routine checking. By routine checking we traditionally think of extensive checking and vouching of all entries.

The extent of the checking to be undertaken is primarily a matter of judgment of the auditor; there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. It is also not obligatory that the auditor must adopt the sampling technique. What he is to do is to express his opinion and become bound by that.

To ensure good and reasonable standard of work, he should adopt standards and techniques that can lead him to an informed professional opinion. On a consideration of this fact, it can be said that it is in the interest of the auditor that if he decides to form his opinion on the basis of a part checking, he should adopt standards and techniques which are widely followed and which have a recognised basis. Since statistical theory of sampling is based on a scientific law, it can be relied upon to a greater extent than any arbitrary technique which lacks in basis and acceptability. The factors that should be considered for deciding upon the extent of checking on a sampling plan are following :

(i) Size of the organisation under audit.

(ii) State of the internal control.

(iii) Adequacy and reliability of books and records.

(iv) Tolerable error range.

(v) Degree of the desired confidence.

It has already been pointed out that in most of the circumstances, the evidence available is not conclusive and the auditor always takes a calculated risk in giving his opinion. Even by undertaking hundred percent checking of the transactions, the auditor does not derive

absolute satisfaction. This state of uneasiness led pragmatic auditors to adopt the statistical theory of sampling to derive the necessary satisfaction about the state of affairs by checking only a part of the total population of entries. Auditors realised that they can derive good satisfaction by undertaking a much lesser checking by adoption of this technique in the auditing process. It is a mathematical truth that the sample, if picked purely on a random basis would reveal the features and characteristics of the population.

By adopting the sampling technique, the auditor only checks a part of the whole mass of transactions. The satisfaction he used to derive earlier, by checking all the transactions, can be derived by a sample checking provided he can put reliance on the internal controls and checks within the clients organisation. Because they provide the reliability of the records, what should be the extent of desirable checking in any particular matter is for auditor to judge on basis of his opinion about the state of control in a particular area. If control is satisfactory in its design and implementation, a much smaller sample can give the auditor the necessary reliability of the result he obtains. On the other hand, if in certain areas controls are slack or not properly implemented, the auditor may have to take a much larger sample for getting satisfactory result.

Another truth about the sampling technique should be noted. It can never bring complete reliability; it cannot give precisely accurate results. It is a process of estimation. It may have some error. What error is tolerable for a particular matter under examination is a matter of the individual's judgment in that particular case. For example, Mr. X may consider that in his estimation of stores valuation, an error of 2% may not be material; he also decides that he needs at least 98% reliability of the result. He is to pick up the requisite number of items of the stores for reliability of the result. The requisite number he can get from the random number table. The question of reliability of the result is directly linked with the reliability of the internal control and of the books and records; when these are satisfactory, lesser degree of reliability of the sampling estimation may suffice — if these are not satisfactory, the auditor may have to decide upon a higher degree of reliability which can only be obtained from a larger sample.

3.13.1 Test Checking

Very often we come across this term when an audit is conducted on the basis of a part checking. This, it is said, owes its origin to the statistical theory of sampling.

The auditor according to his best judgment, having regard to the nature, size and materiality of transactions, picks up the entries for examination. Normally, entries involving large amounts or relating to material accounts are seen exhaustively and entries are picked up for verification at random from the remainder according to a certain plan.

Sometimes, entries are checked for a few specified months exhaustively and the rest go unchecked. Though it is stated that the technique is an adaptation of the sampling theory, it is in reality far from it. It lacks any acceptable basis and gives the auditor no idea about the degree of reliability that he can place on the findings for application to the whole set of entries. The so-called random picking is not random in the statistical sense. To be truly random, the selection should be free from any bias and that is possible only through a statistical process and by reference to the random number tables.

The only quality that this technique can claim lies in its keenness to cover larger amounts and material accounts. Even if errors, frauds etc., remain undetected in the part not checked, they are not likely to be too big as to upset the truth and fairness of the financial statement. But auditors cannot be certain about this even after checking 100% of transactions. The cost and time involved in conducting an audit has to be visualised in relation to benefits which shall accrue from such an approach. If fairly lesser amount of checking may lead to admit same conditions there is absolutely no point in checking entire transaction. Moreover, there are constraints within audit has to be completed.

In any audit, the question of fact is more important because essentially the auditor's job is to test the assertions in financial statements by reference to available evidence, apart from the following aspects:

(i) presentation,

(ii) disclosure,

(iii) arithmetical accuracy,

(iv) adherence to accepted accounting principles, and

(v) compliance with the requirements of law.

An auditor is also concerned about the existence of errors and frauds in the financial accounts. The few matters listed above are fundamental questions affecting the true and fair concept and due consideration to these are given at the appropriate stage of audit. However, errors and frauds stand on a slightly different footing inasmuch as there is a need to eliminate them if they exist to affect truthfulness and fairness materially. It is therefore necessary that an auditor should have a fair idea about why error and frauds occur, how they are committed and what are the usual means to locate them.

3.13.2 Precautions to be taken in Adopting Test Checking Techniques

Generally, a large manufacturing concern is associated with a large volume of transactions. Also, the nature of the transactions is determined by the nature of the

business. For example, one may find numerous purchases of raw materials, stores, spares, etc.; there may be thousands of workers to be paid wages on weekly basis; the wages again may be calculated on a job or time basis. Depending upon the product lines, the sales mechanics may be different for different products - some may be to dealers and agents, some to wholesalers and some others even to retailers and consumers directly. Sales and purchase operations may stretch even to overseas markets. There may be various forms in which such a concern can raise bank finance, like letter of credit, packing credit, overdraft, bills discounted, etc. Basically, in a large manufacturing concern the problem is the problem of volume and variety.

In the circumstances when necessarily the test check technique has got to be adopted for audit work, it should be done by taking certain precautions so that a reliable idea about the truth and fairness of the accounts can be obtained by the auditor. The precautions that should be taken may be the following :

(i) The transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of the same kind.

(ii) Systems and procedures for entering into and processing a transaction right from the beginning to the end should be studied in a sequential order. It involves questions of authorisations, documentation and recording and evidencing the same.

(iii) The whole of the system of internal control in the areas of accounts and finance should be studied and evaluated for its efficiency, soundness and capability for producing reliable accounting and financial data. This can be done by studying the controls and internal checks, evaluating their general soundness in the context of the business of the concern and testing their actual operation. If, and only if, the auditor is satisfied about soundness of the controls and their operation in actuality, can he decide to have test checks. For testing the operation of the control system, he should select a few transactions and check them in depth by the application of procedural tests.

(iv) A properly thought-out test check plan should be prepared and the objective of each check should be clearly understood by the auditing staff. For example, each voucher may be checked by the test check method for a number of objectives - one may be to ensure that the cash payments are properly authorised and acknowledged, others may be to see whether the amount actually payable has in fact been paid and whether the payment has been debited to the proper account. If there is a mix-up in the objectives or the objective is to test a number of variables in one test scheme, the result may not be helpful. Hence it requires a clear definition of the audit objective related to the particular test check plan.

(v) The transactions falling under each test-check plan should be selected in a manner so that bias cannot enter in the selection. For the purpose, selection should be made by reference to the random number tables.

(vi) Identification of the areas where test check may not be done. For example, if there are only 20 overseas sales in the year, it would be preferable to have them all thoroughly checked.

(vii) The number of transactions to be selected for each test-check plan should be predetermined. This can be done by deciding upon the degree of reliance that should be placed on the test-check result and the confidence that can be placed - the result to be obtained should be veering round the degree of reliance set up. Once the degree of reliance and the confidence level required in the audit for expression of the opinion have been decided, the number to be tested out of the given population can be easily known by reference to the statistical tables.

(viii) Errors that may be found may be material or immaterial in the context of the particular audit. Since errors of immaterial nature are not likely to distort the overall truth and fairness of the accounts, it is necessary to decide upon the criteria to judge what constitutes a material error. Further investigation of immaterial error may be avoided and only the material errors may be properly and thoroughly investigated.

3.13.3 Methods of Statistical Sampling

As per SA 530, "Audit Sampling", the auditor should select sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected.

There are two major methods in which the size of the sample and the selection of individual items of the sample are determined. These methods are : (1) judgmental sampling; and (2) statistical sampling.

Whatever may be the method, judgmental or statistical sampling, the sample must be representative. This means that it must be closely similar to the whole population although not necessarily exactly the same. The sample must be large enough to provide statistically meaningful results.

Judgmental Sampling : Under this method, the sample size and its composition are determined on the basis of the personal experience and knowledge of the auditor. This method has been in common application for many years because of its simplicity in operation. Traditionally, the auditor on the basis of his personal experience, will determine the size of the sample and express it in terms that number of pages or personal accounts in the purchases or sales ledger to be checked. For example, March, June and September

may be selected in year one and different months would be selected in the next year. An attempt would be made to avoid establishing a pattern of selection year after year to maintain an element of surprise as to what the auditor is going to check. It is a common practice to check large number of items towards the close of the year so that the adequacy of cut-off procedures can also be determined.

The judgmental sampling is criticised on the grounds that it is neither objective nor scientific. The expected degree of objective cannot be assured in judgmental sampling because the risk of personal bias in selection of sample items cannot be eliminated. The closeness of the qualities projected by the sample results with that of the whole population cannot be measured because the sample has not been selected in accordance with the mathematically based statistical techniques. However, it may be stated that the auditor with his experience and knowledge of the client's business can evaluate accurately enough the sample findings to make audit decision and the mathematical proof of accuracy in some cases may be a luxury which the auditor cannot afford.

In judgmental sampling the auditor's opinion determines the sample size but it cannot be measured how far the sample size would fulfill the audit objective. In statistical sampling, the sample results are measurable as to the adequacy and reliability of the audit objectives.

Statistical Sampling : Statistical sampling is a method of audit testing which is more scientific than testing based entirely on the auditor's own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, debtors' confirmation, payroll checking, vouching of invoices and petty cash vouchers.

Students may note that it is unnecessary for the auditor to gain indepth knowledge of statistics before making use of statistical sampling for audit testing since published statistical tables are available which indicate the sample size based on pre-determined criteria.

3.13.4 Selection of the Sample

Sample should be selected in such a manner that it is representative of the population from which the sample is being selected. It will necessitate that each item in the population has an equal chance of being included in the sample. Some of the important methods of selecting the sample are discussed below -

1. *Random Sampling* : Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below:–

(i) *Simple random sampling* : Under this method each unit of the whole population *e.g.* purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, debtors balances fall within the range of Rs. 5,000 to Rs. 25,000 and not in the range between Rs. 25 to Rs. 2,50,000.

(ii) *Stratified Sampling* : This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it were a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example in the above case, debtors balances may be divided into four groups as follows:-

(a) balances in excess of Rs. 1,00,000;

(b) balances in the range of Rs. 75,000 to Rs. 1,00,000;

(c) balances in the range of Rs. 25,000 to Rs. 75,000; and

(d) balances below Rs. 25,000.

From these above groups the auditor may pick up different percentage of items from each of the group. From the top group *i.e.* balances in excess of Rs. 1,00,000, the auditor may examine all the items; from the second group 25 per cent of the items; from the third group 10 per cent of the items; and from the lowest group 2 per cent of the items may be selected.

The reasoning behind the stratified sampling is that for a highly diversified population, weights should be allocated to reflect these differences. This is achieved by selecting different proportions from each strata. It can be seen that the stratified sampling is simply an extension of simple random sampling.

2. *Interval sampling or systematic sampling* : It involves selecting items using a constant interval between selections, the first interval having a random start. The interval

might be based on a certain number of items (for example every 20th voucher) or a monetary totals (for example every Rs. 1,000 in the cumulative value of the population). When using systematic selection, the auditor should determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch sales occur only as every 100th item and the sampling interval selected is 100. The result would be that either the auditor would have selected all or none of the sales of that particular branch. To minimise the effect of the possible known buyers through a pattern in the population, more than one starting point may be taken. The multiple random starting point is taken because it minimises the risk of interval sampling pattern with that of the population being sampled.

(*i*) *Block Sampling* : This method involves the selection of a defined block of consecutive items. For example take the first 200 sales invoices from the sales day book in the month of September, alternatively take any four blocks of 50 sales invoices. Therefore, once the first item in the block is selected, the rest of the block follows an items to the completion. There is a close similarity between this method and judgmental sampling. Consequently it has similar characteristics, namely, simplicity and economy. On the other hand there is a risk of bias and of establishing a pattern of selection which may be noted by the auditees.

(*ii*) *Cluster sampling* : This method involves dividing the population into groups of items known as clusters. A number of clusters are randomly selected from all the clusters rather than individual items of the population. Cluster sampling can be used together with both unrestricted random and stratified sampling, for example 500 to 540, 2015 to 2055 etc. The first item *i.e.* 500, 2015 is randomly selected from random number tables. The items of selected cluster can either be checked completely or a randomly selected proportion of them can be examined.

The cluster is less effective for a given sample size than unrestricted random and stratified samples as items are not individually selected. However, the time saved can be utilised to have a larger sample to make the sample results more reliable. As per SA 530, when determining the sample size, the auditor should consider sampling risk, the tolerable error, and the expected error. Sampling risk arises from the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

3.13.5 Advantages of Statistical Sampling in Auditing

The advantages of statistical sampling may be summarized as follows -

1. The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
2. The sample selection is more objective and thereby more defensible.
3. The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
4. It provides a means for deriving a "calculated risk" and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
5. It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.

Under some audit circumstances, statistical sampling methods may not be appropriate. The auditor should not attempt to use statistical sampling when another approach is either necessary or will provide satisfactory information in less time or with less effort, for instance when exact accuracy is required or in case of legal requirements etc.

3.14 AUDIT RISK

Students may recall that according to SA 200A, on "Objective and scope of Financial Statements", there is unavoidable risk that even some material misstatements may remain undiscovered due to the test nature and other inherent limitations of any system of internal control. SA-500 on "Audit Evidence" also makes it clear that an auditor's judgement as to what is sufficient and appropriate audit evidence is affected by the degree of risk of mis-statement. Therefore, it becomes significant that an auditor is aware of risks which are inherent in any audit with reference to materiality of transactions involved and accordingly test and evaluate internal control systems so as to assess the extent of risk. In the following paragraphs, first of all various facts of audit risks are discussed followed by relationship between materiality and audit risk.

Low-risk areas are those which require the application of routine "nuts and bolts" audit procedures in the ordinary course of vouching, casting, checking, etc., at both compliance and substantive stages, usually occupying up to 80% of all audit effort. High-risk areas are those which should be the primary concern of partners and senior managers, and will include such matters as:

(a) adequacy of provisions;

(b) full disclosure of liabilities, including contingent liabilities;

(c) interpretation of SAs and company legislation;

(d) post–balance sheet review of subsequent events;

(e) analytical reviews on draft financial statements;

(f) implications of tax legislation;

(g) detecting overstatement of assets, e.g. by capitalising expenditure;

(h) identifying high-value items and 'error-prone' conditions, and

(i) drafting the audit report itself.

3.14.1 Concept of audit risk

Audit risk is the risk that an auditor may give an inappropriate opinion on financial information that is materially mis-stated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially mis-stated. Such risk may exist at overall level or while verifying various transactions and balance-sheet items.

1. Audit risk at the financial statement level : Audit risk is considered at the financial statement level during the audit planning process. At this time, the auditor should undertake an overall audit risk assessment based on his knowledge of the client's business, industry, management, control environment and operations. Such an assessment provides preliminary information about the general approach to the engagement, the auditor's staffing needs and the framework within which materiality and audit risk assessments can be made at the individual account balance or class of transactions level. As part of this overall risk assessment, the auditor should consider whether there is potential for pervasive problems, for example, liquidity or going concern problems.

2. Audit risk at the account balance and class of transactions level: The majority of audit procedures are directed to, and carried out at the account balance and class of transactions level. Accordingly, audit risk should be considered by the auditor at this level taking into account the results of the overall audit risk assessment made at the financial statement level. To assess inherent risk, the auditor uses professional judgement to evaluate numerous factors, examples of which are:

At the financial statement level :

- the integrity of management;
- management experience, knowledge and changes during the period (e.g. the in experience of management may affect the preparation of the financial statements of the entity);
- unusual pressures on management (e.g. circumstances that might predispose management to mis-state the financial statements, such as an entity in an industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations);
- the nature of the entity's business (e.g. its technological obsolescence of products and services, complex capital structure, significance of related parties, and the number of locations and geographical spread of its production facilities); factors affecting the industry in which the entity operates (e.g. economic and competitive conditions, and changes in technology, accounting practices common to the industry and, if available, financial trends and ratios);

At the Account balance and class of transaction level:

- financial statement of accounts likely to be susceptible to misstatement (e.g. a financial statement of account which required adjustment in the previous period);
- the complexity of underlying transactions which might require the use of the work of an expert;
- the amount of judgement involved in determining account balances;
- susceptibility of assets to loss or misappropriation;
- the completion of unusual and complex transactions, particularly at or near year end;

Assessment of audit risk by reference to its components : Audit risk has been discussed at length in SA-400. As per SA-400 three components of audit risk are:

- inherent risk (risk that material errors will occur);
- control risk (risk that the client's system of internal control will not prevent or correct such errors); and
- detection risk (risk that any remaining material errors will not be detected by the auditor).

The nature of each of these types of risk and their interrelationship is discussed below:

Inherent risk is the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with mis-statements in other balances or classes, assuming that there were no related internal controls. It is a function of the entity's business and its environment and the nature of the account balance or class of transactions. For example, accounts involving a high degree of management judgement, or that are difficult to compute, such as a complex accounting estimate, or that involve highly desirable and movable assets, such as jewellery, or that are particularly susceptible to changes in consumer demand or technology that could affect their value, will involve more inherent risk than other accounts.

Control risk is the risk that misstatement that could occur in an account balance or class of transactions and that could be material, individually or when aggregated with mis-statements in other balances or classes, will not be prevented or detected on a timely basis by the system of internal control. There will always be some control risk because of the intrinsic limitation of any system of internal control. To assess control risk, the auditor should consider the adequacy of control design, as well as test adherence to control procedures. In the absence of such an assessment, the auditor should assume that control risk is high.

Detection risk is the risk that an auditor's procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes. The level of detection risk relates directly to the auditor's procedures. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balance or class of transaction because, for example, the auditor may select an inappropriate audit procedure, misapply an appropriate audit procedure or misinterpret the audit results.

Interrelationship of the components of audit risk : Inherent and control risks differ from detection risk in that they exist independently of an audit of financial information. Inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce an acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

3.14.2 Materiality and Audit Risk

SA-320 on "Audit Materiality" requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. According to it, information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item, judged in the particular circumstances of its misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful. It stresses that the assessment of what is material is a matter of professional judgement.

The audit should be planned so that audit risk is kept at an acceptably low level. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgement, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high. The auditor reduces detection risk by performing substantive procedures - the more extensive the procedures performed, the lower the detection risk. The nature and timing of substantive procedures will also affect the detection risk, for example, confirmation with third parties will lead to lower detection risk than reliance on internal data, as will procedures carried out closer to year-end.

The auditor's assessment of audit risk may change during the course of an audit. For example, in planning the audit, the auditor may believe that he has low inherent and control risk based on his assessment of the probability of errors occurring and on his review and testing of the system of internal control. After performing audit procedures, however, the auditor may conclude that his earlier assessment was too low. In this case, he will have to carry out additional audit procedures in order to reduce the level of detection risk and achieve audit risk at the level originally planned.

3.15 SURPRISE CHECKS

The surprise checks also constitute an important part of normal audit procedures as per the Guidance Note on" "Surprise Checks". Audit procedures cannot consist merely of any set of rules or precepts to be applied to all and every situation but must be allowed to develop in the light of experience with regard to the circumstances of each audit. An element of surprise can significantly improve the effectiveness of an audit and therefore, wherever practicable, an element of surprise should be incorporated into the audit programme.

The element of surprise in an audit can be both with regard to the time of the audit, that is the selection of the date at which the auditor visits the clients' office to carry out the audit and the selection of the items which are subjected to audit.

Surprise checks are mainly intended to ascertain whether the system of internal control is operating effectively and whether the accounting and other records are prepared concurrently and kept up-to-date. It has often been found that manipulations and frauds are facilitated under a system of book-keeping which does not give proper emphasis to the need to keep the books up-to-date. Errors in book-keeping are often indicative of weaknesses in internal control which may be taken advantage of in order to perpetrate frauds or manipulations. Surprise checks are a useful method of determining whether or not such errors exist and where they exist, of bringing the matter promptly to the attention of the management so that corrective action is taken immediately. Consequently, surprise visits by the auditor can exercise a good moral check on the client's staff.

While surprise checks would generally be appropriate in most cases, they are particularly appropriate in cases where the auditor is not satisfied with regard to the system of internal control, or where the company is a very large one or has diversified activities or numerous branches, leading to remoteness of control between top management and various persons in charge of the company's operations at different locations. Surprise checks are also particularly relevant in respect of certain items, for example, cash, investments, stores and stocks, statutory registers normally required to be examined for the purposes of audit, etc. They also have great relevance to ensure that the books of prime entry, for example, the cash book, sales and purchase journals etc. have been kept up-to-date. When EDP system is being used, surprise checks, through the use of test-checks etc. are important to ensure that the programmes are operating satisfactorily.

The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

In the case of an audit of a company the auditor is appointed at the Annual General Meeting to hold office until the next Annual General Meeting. He is not appointed for a particular accounting year. Consequently, he has the right of examination of the accounts and records of the company at any time during the period covered by his appointment, insofar as it is necessary for the purposes of his report. He may, therefore, carry out

surprise checks of transactions beyond the end of the accounting year for which he is reporting.

Surprise checks are a part of the normal audit and the results of such checks are therefore important primarily to the auditor himself in deciding the scope of his audit and submitting his report thereon. If the surprise check reveals a weakness in the system of internal control or any fraud or error or the fact that any book or register has not been properly maintained or kept up-to-date, the auditor should communicate the same to the management and ensure that action is taken on the matters communicated by him. It does not necessarily follow that all or any of the matters communicated to the management should form part of the auditor's report on the accounts. Whether the items should also be included in the auditor's report on the accounts is a matter for each auditor to decide in the light of the circumstances of each case. In arriving at his decision he must consider, *inter alia,* the magnitude of the amounts involved, whether the error or deficiencies pointed out have been rectified or the weaknesses in the internal control system corrected and the extent to which the accounts reported upon are affected by the matters stated by him in his report to the management.

The Council therefore makes the following recommendations:

(1) Surprise checks should be considered as a desirable part of each audit.

(2) The areas over which surprise checks should be employed would depend upon the circumstances of each audit but should normally include:

  (a) Verification of cash and investments

  (b) Test-verification of stores and stocks and the records relating thereto

  (c) Verification of books of prime entry and statutory registers normally required to be examined for the purposes of audit.

(3) The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(4) The results of the surprise checks should be communicated to the management if they reveal any weakness in the system of internal control or any fraud or error or deficiency in the maintenance of records.

(5) The auditor should satisfy himself that adequate action is taken by the management on the matters communicated by him.

(6) It is not necessary in all cases for the results of the surprise checks to be included in the auditors' report on the accounts. They should, however, be included if in the opinion of the auditor they are material and affect a true and fair view of the accounts on which he is reporting.

3.16 OBTAINING CERTIFICATE FROM MANAGEMENT

While conducting an audit, the auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. One such area involves verification of liabilities, in general, and contingent liabilities in particular. In such cases, it is advisable for the auditor to obtain a written representation from the management as to the fact whether all contingent liabilities have been disclosed and are complete in all respects. Even in normal circumstances, obtaining a certificate from the management would provide a corroborating evidence to support the evidence obtained from other sources. In any case, the fact remains that it is the management which is responsible for preparation of financial information. Therefore, it would be in order to obtain an appropriate certificate from the management that it has approved the financial information prepared by them. Now section 217(2AA) of the Companies Act, 1956 provides that the Board shall have to give a statement that financial statements are their responsibility.

SA-580, "Representation by Management", while amplifying the procedures to be applied in evaluating and documenting one representation from management, it makes it absolutely clear that representations by management cannot be a substitute for other evidence that the auditor could expect to be reasonably available. For example, a representation by management as to the quantity, existence and cost of inventories is no substitute for adopting normal audit procedures regarding verification and valuation of inventories. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes would be available regarding a matter which has or may have a material effect on the financial information, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter.

Self-examination Questions

1. State the claims made by a company that includes the following items in the annual statements of account

		Rs.
(i)	Land (as revalued)	2,00,000
(ii)	Purchases	1,70,00,000

(iii)	Goodwill (at cost)	3,00,000
(iv)	Miscellaneous income	46,800
(v)	Loan (secured by fixed Assets)	28,00,000
(vi)	Pre-paid expenses	63,300

2. The following items appear in the annual statements of account of a manufacturing company and against the item and related instructions in the audit programme are given. If the instructions are considered inadequate, give your reasoned comments.

   (a) Sales-compare the Account Section copy of the invoices with entries in the sales register.

   (b) Closing Stock - investigate physical existence of major items in stock.

   (c) Share transfer fee - check counterfoil of the receipt issued with related cash book entry.

   (d) Sundry Creditors - compare the list of the Sundry Creditors with the balances in the personal ledger and the Sundry Creditors Account in the General Ledger.

   (e) Dividend Income - check the receipts by reference to Investment Register.

   (f) Secured loan - verify by reference to the Register of Charges.

3. An auditor is to report on the truth and fairness of the statements of account. Describe, in general terms, the procedure he must follow in order to form an opinion for the report.

4. Explain the utility of working papers to an auditor.

5. There are two working paper files - permanent and current. Trace the following to the appropriate file:

   (i) Schedule for general charge

   (ii) Plant and machinery purchased

   (iii) Method of computation of depreciation

   (iv) Confirmation about stock in bonded warehouse

   (v) Nature and type of business that the client is authorised to carry on

Multiple Choice Questions

1. Which of the following methods of sample selection is least suitable for extrapolating results to the population ?
   (a) Systematic Sampling
   (b) Random sampling
   (c) Haphazard sampling
   (d) None of the above.
2. Which of the following statements is correct ?
   (a) Lower the sampling risk, greater the sample size
   (b) Smaller the tolerable error, greater the sample size
   (c) Lower the expected error, smaller the sample size
   (d) All are correct
3. Which of the following features is most important for random-based selection ?
   (a) Sample should be drawn from population
   (b) Every strata of population should be represented in the sample
   (c) Every item in the population has an equal chance of being selected in the sample
   (d) Items should be selected at 'n' th interval
4. Risk of under reliance is the risk that the sample selected to test controls —
   (a) Does not support the auditor's planned assessed level of control risk when the true operating effectiveness of the control structure justifies such an assessment
   (b) Supports the auditor's planned assessed level of control risk when the actual positions does not warrant such reliance
   (c) Is not supported by adequate documents
   (d) (a) and (c) together

5. Which of the following factors is (are) considered in determining the sample size for tests of control ?

   (a) Projected error

   (b) Tolerable error

   (c) Expected error

   (d) Both (b) and (c)

6. Tolerable error, is the maximum monetary error that the auditor is prepared to accept in the population and still conclude that audit objective has been achieved, is directly related to

   (a) Sample size

   (b) Audit risk

   (c) Materiality

   (d) Expected error

7. Audit Engagement Letters should be sent

   (a) preferably before commencement of the engagement

   (b) after completion of the engagement

   (c) during the engagement

   (d) whenever required

8. The auditor should not agree to change of engagement

   (a) where there is no reasonable justification for doing so

   (b) where there is reasonable justification for doing so

   (c) if he is not interested to do so

   (d) either b or c

9. Communication with those charged with governance may be made

   (a) orally

   (b) in writing

(c) either orally or in writing

(d) both orally and in writing

10. In case of potential conflicts with the auditors ethical and legal obligations he need to consult

(a) family counseller

(b) professional counseller

(c) legal counsel

(d) either a or b

CHAPTER 4

INTERNAL CONTROL

Learning Objectives

After reading this chapter you will able to conceptualize –

- Internal control, inherent limitation of internal control. The relationship of internal control and management.
- The responsibility of auditor to communicate weaknesses of internal control to management.
- The internal control & computerized information system environment.
- In fine, internal check and internal audit, the requirements of CARO 2003.

Control is a basic human requirement and it has existed throughout the ages in different facets of human activity. Business as such is a complex process and has grown even more complex with the technological advancement of the society. The formalisation of the concept of internal control in the sphere of business administration is a comparatively recent phenomenon.

In the sphere of a business, control is an accepted device for optimum utilisation of the resources and opportunities for maximisation of profits. All operations of a business are carried on with the help of human agents and equipment; both these factors need supervision so that the tasks assigned to them are properly carried out and avoidable wastes and losses do not occur to eat up the fruit of the enterprise.

The internal control required by a sole proprietor of small business is not identical with that required for a large industrial organisation. A small trader having a grocery shop hardly needs more than one or two assistants. He decides the work to be done by the assistants. He always knows his own stock, cash and bank position. He has the knowledge of daily sales. He himself knows the sources for purchases. He arranges transport and makes the purchases. He keeps the record of the debtors and creditors. The assistants merely help him in delivering goods to customers or to arrange the goods in proper order.

From the above, it can be observed that control is entirely centralised with the owner and there is no significant delegation of duties. However, as the business grows in size it soon reaches a stage where the owner can no longer keep himself intimately informed about the detailed operations of his business, activities of the employees and the discharge of their responsibilities. To cope with the increasing size and volume of business, he has to employ more and more people and for systematically carrying on the business, he has to specify the tasks for each person. For remote operations he has also to rely upon these people, for carrying out the work, for the custody of the materials, documents and equipments entrusted to them. He has also to ensure that the equipment and facilities are properly maintained. For this purpose, he has to give shape to a form of organisation from which he would be in a position to know the broad details of the work involved and the persons responsible for such work. Also, he has to work out a plan of delegation of duties and authority for the simple reason that, for anything and everything, people need not come to him for advice or decision, because, under such circumstances, he would not be able to find time to apply his mind to matters of more importance.

Human behaviour is such that if it is not under some sort of regulation or control, it often tends to depart from the proper path. It needs to be kept under systematic watch not only for ensuring that the employee does his work, but also to see that he does it in the manner laid down for the purpose and handles the material and equipment with proper care.

4.1 CONCEPT OF INTERNAL CONTROL

According to SA-400 entitled, "Risk Assessment and Internal Control", the system of internal control may be defined as "the plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The system of internal control extends beyond those matters which relate directly to the functions of the accounting system. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated."

Objectives of Internal Control : SA-400 lists the following objectives of internal control in relation to an accounting systems :

(a) transactions are executed in accordance with managements general or specific authorization;

(b) all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets;

(c) assets are safeguarded from unauthorised access, use or disposition; and

(d) the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

4.2 ENVIRONMENT OF INTERNAL CONTROL

The environment in which internal control operates has an impact on the effectiveness of the specific control procedures. The control environment means the overall attitude awareness and actions of directors and managements regarding the internal control system and its importance in the entity. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the overall system of internal control. The internal control environment may be affected by :

(a) *Organisational structure* : The organisational structure of an entity serves as a framework as practicable, to preclude an individual from overriding the control system and should provide for the segregation of incompatible functions. Functions are incompatible if their combination may permit the commitment and concealment of fraud or error. Functions that typically are segregated are access to assets, authorisation, execution of transactions, and record keeping.

(b) *Management supervision* : Management is responsible for devising and maintaining the system of internal control. In carrying out its supervisory responsibility, management should review the adequacy of internal control on a regular basis to ensure that all significant controls are operating effectively. When an entity has an internal audit department, management may delegate to it some of its supervisory functions, especially with respect to the review of internal control. This particular internal audit function constitutes a separate component of internal control undertaken by specially assigned staff within the entity with the objective of determining whether other internal controls are well designed and properly operated.

(c) *Personnel* : The proper functioning of any system depends on the competence and honesty of those operating it. The qualifications, selection and training as well as the personal characteristics of the personnel involved are important features in establishing and maintaining a system of internal control.

It is clear from above that internal control means not only internal check and internal audit but it encompasses the whole system of accounting as well as non-accounting controls established by the management in order to carry on the business of the company in an orderly manner, safeguard its assets and secure as far as possible the accuracy and reliability of its records. It also follows that a good system of internal control should comprise among other the following;

(i) the proper allocation of functional responsibilities within the organisation;

(ii) proper operating and accounting procedures to ensure the accuracy and reliability of accounting data, efficiency in operation and safeguarding of assets;

(iii) quality of personnel commensurate with their responsibilities and duties; and finally

(iv) the review of the work of one individual by another whereby the possibility of fraud or error in the absence of collusion is minimised.

Further, it is clear from the definition that the scope of internal control can be extended beyond accounting and financial matters. However, financial and accounting controls primarily concern an accountant; and the other administrative controls installed by the management may have only an indirect significance for him. Non-financial control may include quality control of the products, plant maintenance programme, operating reports, statistical analysis, personnel training programme, etc. Accounting and financial controls include budgetary control, standard costing, bank reconciliation, self-balancing ledgers, periodical operating statements, internal auditing, etc.

4.3 INHERENT LIMITATIONS OF INTERNAL CONTROL

Internal control can provide only reasonable, but not absolute, assurance that the objectives stated above are achieved. This is because there are some inherent limitations of internal control, such as :

(a) management's consideration that a control be cost-effective;

(b) the fact that most controls do not tend to be directed at transactions of unusual nature;

(c) the potential for human error;

(d) the possibility of circumvention of controls through collusion with parties outside the entity or with employees of entity;

(e) the possibility that a person responsible for exercising control could abuse that authority, for example, a member of management overriding a control;

(f) the possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate;

(g) manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

4.4 ACCOUNTING AND FINANCIAL CONTROL

Internal control, so far as financial and accounting aspects are concerned, aims at:

(i) Providing the flow of work through various stages.

(ii) Breaking the chain of the work in a manner so that no single person can handle a transaction from the beginning to the end.

(iii) Segregation of accounting and custodial functions.

(iv) Securing proper documentation at each stage.

(v) Specifying authority to enter into the various transactions and for every action connected therewith.

(vi) Recording the transactions in the books of account correctly.

(vii) Safeguarding of assets.

(viii) Making errors and frauds difficult.

(ix) Fixing responsibility for the work and the responsibility for deviations.

(x) Building up a system to locate the deviations and departures from the prescribed procedures and to detect frauds and errors automatically without much loss of time

(xi) Elimination of conflicting responsibilities.

(xii) Evolving standardised records.

(xiii) Providing account charts and the accounting manual.

(xiv) Preparation of periodical accounting and financial report.

(xv) Making the work simpler as far as practicable.

(xvi) Minimising loss and wastage.

(xvii) Encouraging employees to do willing and good work.

(xviii) Discouraging employees from non-compliance with the prescribed procedures.

(xix) Appraisal of the operations.

(xx) Employment of persons of quality.

(xxi) Formulating a cut-off procedure to separate transactions of two consecutive years.

4.5 INTERNAL CONTROL AND MANAGEMENT

Before any discussion on the effect of internal control on the auditor's work is undertaken it is necessary to appreciate that devising and installation of internal control is the responsibility of the management. In any business, the management is vested with the responsibility of carrying on the business, safeguarding its assets and recording the transactions in the books of account and other records. SA-200 on "Basic Principles Governing an Audit" also states that, "the management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business". It should also be appreciated that in every business organisation, small or big, simple or complex, some sort of control is perceptively or otherwise in operation. It ensures uniform treatment and operation. It outlines the broad line of authority and specifies each one's task. The form and details, however, may vary from organisation to organisation. It is also important to bear in mind that the system installed needs review by the management to ascertain:

(i) whether the prescribed management policies are being properly interpreted by the employees and are faithfully implemented;

(ii) whether the prescribed procedures need a revision because of changed circumstances or whether they have become obsolete or cumbersome; and

(iii) whether effective corrective measures are taken promptly when the system appears to break down.

It is desirable that the management also installs an internal audit system as an independent function to check, amongst other things, the actual operation of the internal control system and report to it the deviations and non-compliances.

4.6 INTERNAL CONTROL AND THE AUDITOR

1. Auditing and Assurance Standard SA-400 , "Risk Assessments and Internal Control" establishes standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. As per this Standard, the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement

to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.

"Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

"Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. To assess To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Examples of such factors are:

At the Level of Financial Statements

- The integrity of the management.
- Management's experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.
- Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
- The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the Level of Account Balance and Class of Transactions

- Quality of the accounting system.

- Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.
- The complexity of underlying transactions and other events which might require using the work of an expert.
- The degree of judgement involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- The completion of unusual and complex transactions, particularly, at or near period end.
- Transactions not subjected to ordinary processing.

5. "Control Risk" is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

Control risk

After obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.

Preliminary Assessment of Control Risk

The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity's accounting and internal control systems in preventing or detecting and correcting material misstatements. The preliminary assessment of control risk is based on the assumption that the controls operate generally as described and that they operate effectively throughout the period of intended reliance. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

The auditor ordinarily assesses control risk at a high level for some or all assertions when:

(a) the entity's accounting and internal control systems are not effective; or

(b) evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

In the above circumstances, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements.

The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:

(a) is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and

(b) plans to perform tests of control to support the assessment.

4.7 REVIEW OF INTERNAL CONTROL BY THE AUDITOR

So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. The review of internal controls will enable the auditor to know:

(i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;

(ii) whether an adequate internal control system is in use and operating as planned by the management;

(iii) whether an effective internal auditing department is operating;

(iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);

(v) whether the controls adequately safeguard the assets;

(vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;

(vii) how reliable the reports, records and the certificates to the management can be;

(viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;

(ix) what would be appropriate audit technique and the audit procedure in the given circumstances;

(x) what are the areas where control is weak and where it is excessive; and

(xi) whether some worthwhile suggestions can be given to improve the control system.

The auditor can formulate his entire audit programme only after he has had a satisfactory understanding of the internal control systems and their actual operation. If he does not care to study this aspect, it is very likely that his audit programme may become unwieldy and unnecessarily heavy and the object of the audit may be altogether lost in the mass of entries and vouchers. It is also important for him to know whether the system is actually in operation. Often, after installation of a system, no proper follow up is there by the management to ensure compliance. The auditor, in such circumstances, may be led to believe that a system is in operation which in reality may not be altogether in operation or may at best operate only partially. This state of affairs is probably the worst that an auditor may come across and he would be in the midst of confusion, if he does not take care.

It would be better if the auditor can undertake the review of the internal control system of client. This will give him enough time to assimilate the controls and implications and will enable him to be more objective in the framing of the audit programmes. He will also be in a position to bring to the notice of the management the weaknesses of the system and to suggest measures for improvement. At a further interim date or in the course of the audit, he may ascertain how far the weaknesses have been removed.

From the foregoing, it can be concluded that the extent and the nature of the audit programme is substantially influenced by the internal control system in operation. In deciding upon a plan of test checking, the existence and operation of internal control system is of great significance.

A proper understanding of the internal control system in its content and working also enables an auditor to decide upon the appropriate audit procedure to be applied in different areas to be covered in the audit programme. In a situation where the internal controls are considered weak in some areas, the auditor might choose an auditing procedure or test that otherwise might not be required; he might extend certain tests to cover a large number of transactions or other items than he otherwise would examine and at times he may perform additional tests to bring him the necessary satisfaction. For

example, normally the distribution of wages is not observed by the auditor. But if the internal control over wages is so weak that there exists a possibility of dummy workers being paid, the auditor might include observation of wages distribution in his programme in order to find out the workers who do not turn up for receipt of wages. On the other hand, if he is satisfied with the internal control on sales and debtors, the auditor can get debtors' balances confirmed at almost any time reasonably close to the balance sheet date. But if the control is weak, he may feel that he should get the confirmation exactly on the date of the year closing so that he may eliminate the risk of errors and frauds occurring between the intervening period. Also, he may in that situation, decide to have a large coverage of debtors by the confirmation procedure.

A review of the internal control can be done by a process of study, examination and evaluation of the control system installed by the management. The first step involves determination of the control and procedures laid down by the management. By reading company manuals, studying organisation charts and flow charts and by making suitable enquiries from the officers and employees, the auditor may ascertain the character, scope and efficacy of the control system. To acquaint himself about how all the accounting information is collected and processed and to learn the nature of controls that makes the information reliable and protect the company's assets, calls for considerable skill and knowledge. In many cases, very little of this information is available in writing; the auditor must ask the right people the right questions if he is to get the information he wants. It would be better if he makes written notes of the relevant information and procedures contained in the manual or ascertained on enquiry.

To facilitate the accumulation of the information necessary for the proper review and evaluation of internal controls, the auditor can use one of the following to help him to know and assimilate the system and evaluate the same :

(i) Narrative record;

(ii) Check List;

(iii) Questionnaire; and

(iv) Flow chart.

4.7.1 The Narrative Record

This is a complete and exhaustive description of the system as found in operation by the auditor. Actual testing and observation are necessary before such a record can be developed. It may be recommended in cases where no formal control system is in operation

and would be more suited to small business. The basic disadvantages of narrative records are :

(i) To comprehend the system in operation is quite difficult.

(ii) To identify weaknesses or gaps in the system

(iii) To incorporate charges arising on account of reshuffling of manpower, etc.

4.7.2 A Check List

This is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable. This is again an on the job requirement and instructions are framed having regard to the desirable elements of control. A few examples of check list instructions are given hereunder:

1. Are tenders called before placing orders?
2. Are the purchases made on the basis of a written order?
3. Is the purchase order form standardised?
4. Are purchase order forms pre-numbered?
5. Are the stock control accounts maintained by persons who have nothing to do with :
   (i) custody of work;
   (ii) receipt of stock;
   (iii) inspection of stock; and
   (iv) purchase of stock?

The complete check list is studied by the Principal/Manager/Senior to ascertain existence of internal control and evaluate its implementation and efficiency.

4.7.3 Internal Control Questionnaire

This is a comprehensive series of questions concerning internal control. This is the most widely used form for collecting information about the existence, operation and efficiency of internal control in an organisation.

An important advantage of the questionnaire approach is that oversight or ommission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in

sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail. In the questionnaire, generally questions are so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

4.7.4 A Flow Chart

It is a graphic presentation of each part of the company's system of internal control. A flow chart is considered to be the most concise way of recording the auditor's review of the system. It minimises the amount of narrative explanation and thereby achieves a consideration or presentation not possible in any other form. It gives bird's eye view of the system and the flow of transactions and integration and in documentation, can be easily spotted and improvements can be suggested.

It is also necessary for the auditor to study the significant features of the business carried on by the concern; the nature of its activities and various channels of goods and materials as well as cash, both inward and outward; and also a comprehensive study of the entire process of manufacturing, trading and administration. This will help him to understand and evaluate the internal controls in the correct perspective.

4.8 TESTING OF INTERNAL CONTROL

After assimilating the internal control system, the auditor needs to examine whether and how far the same is actually in operation. For this, he resorts to actual testing of the system in operation. This he does on a selective basis: he can plan this testing in such a manner that all the important areas are covered in a period of, say, three years. Selective testing is being done by application of procedural tests and auditing in depth.

Tests of Control

Tests of control are performed to obtain audit evidence about the effectiveness of the:

(a) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and

(b) operation of the internal controls throughout the period.

Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk.

Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation.

When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level.

Tests of control may include:

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls.

When obtaining audit evidence about the effective operation of internal controls, the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

It has been suggested that actual operation of the internal control should be tested by the application of procedural tests and examination in depth. Procedural tests simply mean testing of the compliance with the procedures laid down by the management in respect of initiation, authorisation, recording and documentation of transaction at each stage through which it flows. For example, the procedure for sales requires the following:

(i) Before acceptance of any order the position of stock of the relevant article should be known to ascertain whether the order can be executed in time.

(ii) An advice under the authorisation of the sales manager should be sent to the party placing the order, internal reference number, and the acceptance of the order. This advice should be prepared on a standardised form and copy thereof should be forwarded to stock section to enable it to prepare for the execution of the order in time.

(iii) The credit period allowed to the party should be the normal credit period. For any special credit period a special authorisation of the sales manager would be necessary.

(iv) The rate at which the order has been accepted and other terms about transport, insurance, etc., should be clearly specified.

(v) Before deciding upon the credit period, a reference should be made to the credit section to know the creditworthiness of the party and particularly whether the party has honoured its commitments in the past.

An auditor testing the internal controls on sales should invariably test whether any of the aforesaid procedures have been omitted. If credit has actually been granted without a reference to the credit section to know the creditworthiness of the party, it is possible that the amount may prove bad because of the financial crisis or deadlock in the management of the party, a fact which could have been easily gathered from the credit section. Similarly, if an order is received without a reference to the stock section, it is likely due to non-availability of the stock on the stipulated date; execution of the order may be delayed and the company may have to compensate the buyer for the damages suffered by him.

4.9 EXAMINATION IN DEPTH

It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction, i.e., from initiation to the completion of the transaction by receipt of payment of cash and delivery or receipt of the goods. This examination consists of studying the recording of transactions at the various stages through which they have passed. At each stage, relevant records and authorities are examined; it is also judged whether the person who has exercised the authority in relation to the transactions is fit to do so in terms of the prescribed procedure. For example, if payment to a creditor is to be verified “in depth”, it would be necessary to examine the following documents:

(a) The invoice and statement of account received from the supplier.

(b) The entry in the stock record showing that the goods were received.

(c) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.

(d) The copy of the original order and authority showing that the goods in fact were ordered by an authority which was competent to do so.

It is to be emphasised that, so far as the management is concerned, the internal control should have willing acceptance at the hands of the employees and there should exist proper mechanism for such motivation.

4.10 RELATIONSHIP BETWEEN THE ASSESSMENTS OF INHERENT AND CONTROL RISKS

Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

Detection Risk

The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures required to reduce audit risk to an acceptably low level. In this regard the auditor would consider:

(a) the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;

(b) the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and

(c) the extent of substantive procedures, for example, using a larger sample size.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the

other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.

The auditor's assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor's attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

4.11 COMMUNICATION OF WEAKNESSES IN INTERNAL CONTROL

As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention. The communication

to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

4.12 INTERNAL CONTROL IN THE SMALL BUSINESS

The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both small and large entities. However, many controls which would be relevant to large entities are not practical in the small business. For example, in small business accounting work may be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by owner/manager supervisory controls which may exist because of direct personal knowledge of the business and involvement in the business transactions. In circumstances where segregation of duties is limited or evidence of supervisory controls is lacking, the evidence necessary to support the auditor's opinion on the financial information may have to be obtained largely through the performance of substantive procedures.

4.13 INTERNAL CONTROL AND THE COMPUTERISED INFORMATION SYSTEM (CIS) ENVIRONMENT

The principal object of an audit is to ensure that the accounts on which the auditor is reporting to show a true and fair view of the state of affairs at a given date and of the results for the period ended on that date. The essential features of an audit, appropriate for medium or large sized concern, are :

(a) an evaluation of the system of accounting and internal control to ascertain whether they are appropriate for the business and properly record all transactions;

(b) the making of such tests and enquiries as are considered necessary to determine whether the systems are being operated correctly;

(c) an examination of the accounts in order to verify :

  (i) the title, existence and value of the assets appearing in the balance sheet and to verify that all liabilities are correctly included therein;

(ii) that the results shown by the profit and loss account are fairly stated;

and to ensure that such accounts are in accordance with the underlying records and comply with the appropriate statutory requirements.

The overall objective and scope of an audit does not change in an CIS environment. However, the use of a computer changes the processing and storage of financial information and may affect the organization and procedures employed by the entity to achieve adequate internal control. Accordingly, the procedures followed by the auditor in his study and evaluation of the accounting system and related internal controls and nature, timing and extent of his other audit procedures may be affected by an EDP environment.

Skills and Competence : When auditing in an CIS environment, the auditor should have an understanding of computer hardware, software and processing systems sufficient to plan the engagement and to understand how CIS affects the study and evaluation of internal control and application of auditing procedures including computer-assisted audit techniques. The auditor should also have sufficient knowledge of CIS to implement the auditing procedures, depending on the particular audit approach adopted.

Work Performed by Others : The auditor is never able to delegate his responsibility for forming important audit conclusions or for forming and expressing his opinion on the financial information. Accordingly, when he delegates work to assistants or uses work performed by other auditors or experts, the auditor should have sufficient knowledge of CIS to direct, supervise and review the work of assistants with CIS skills or to obtain reasonable assurance that the work performed by other auditors or experts with CIS skills is adequate for his purpose, as applicable.

Planning : The auditor should gather information about the CIS environment that is relevant to the audit plan, including information as to:

- How the CIS function is organized and the extent of concentration or distribution of computer processing throughout the entity.
- The computer hardware and software used by the entity.
- Each significant application processed by the computer, the nature of the processing (e.g. batch, on-line), and data retention policies.
- Planned implementation of new applications or revisions to existing applications.
- When considering his overall plan the auditor should consider matters, such as:

- Determining the degree of reliance, if any, he expects to be able to place on the CIS controls in his overall evaluation of internal control.
- Planning how, where and when the CIS function will be reviewed including scheduling the works of CIS experts, as applicable.
- Planning auditing procedures using computer-assisted audit techniques.

Accounting System and Internal Control : During the review and preliminary evaluation of internal control, the auditor should acquire knowledge of the accounting system to gain an understanding of the overall control environment and the flow of transactions. If the auditor plans to rely on internal controls in conducting his audit, he should consider the manual and computer controls affecting the CIS function (general CIS controls) and the specific controls over the relevant accounting applications (CIS application controls).

Audit Evidence : An CIS environment may affect the application of compliance and substantive procedures in several ways.

The use of computer assisted audit techniques may be required because:

- The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
- The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
- The lack of visible output may necessitate access to data retained on files readable only by the computer.

The timing of auditing procedures may be affected because data may not be retained in computer files for a sufficient length of time for audit use, and the auditor may have to make specific arrangements to have it retained or copied.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

(i) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.

(ii) In applying analytical review procedures, transactions or balance details may be reviewed and reports printed of unusual items more efficiently by using the computer than by manual methods.

4.13.1 Organizational Structure in an CIS Environment

In an CIS environment, an entity will establish an organizational structure and procedures to manage the CIS activities. Characteristics of an CIS organizational structure include:

a. *Concentration of functions and knowledge*—although most systems employing CIS methods will include certain manual operations, generally the number of persons involved in the processing of financial information is significantly reduced. Furthermore, certain data processing personnel may be the only ones with a detailed knowledge of the interrelationship between the source of data, how it is processed and the distribution and use of the output. It is also likely that they are aware of any internal control weaknesses and, therefore, may be in a position to alter programs or data while stored or during processing. Moreover, many conventional controls based on adequate segregation of incompatible functions may not exist, or in the absence of access and other controls, may be less effective.

b. *Concentration of programs and data*—transaction and master file data are often concentrated, usually in machine-readable form, either in one computer installation located centrally or in a number of installations distributed throughout an entity. Computer programs which provide the ability to obtain access to and alter such data are likely to be stored at the same location as the data. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and alteration of, programs and data.

Nature of Processing : The use of computers may result in the design of systems that provide less visible evidence than those using manual procedures. In addition, these systems may be accessible by a larger number of persons. System characteristics that may result from the nature of CIS processing include:

a. *Absence of input documents*—data may be entered directly into the computer system without supporting documents. In some on-line transaction systems, written evidence of individual data entry authorization (e.g. approval for order entry) may be replaced by other procedures, such as authorization controls contained in computer programs (e.g. credit limit approval).

b. *Lack of visible transaction trail*—certain data may be maintained on computer files only. In a manual system, it is normally possible to follow a transaction through the system by examining source documents, books of account, records, files and reports. In an CIS

environment, however, the transaction trail may be partly in machine-readable form, and furthermore it may exist only for a limited period of time.

c. *Lack of visible output*—certain transactions or results of processing may not be printed. In a manual system, and in some CIS systems, it is normally possible to examine visually the results of processing. In other CIS systems, the results of processing may not be printed, or only summary data may be printed. Thus, the lack of visible output may result in the need to access data retained on files readable only by the computer.

d. *Ease of access to data and computer programs*—data and computer programs may be accessed and altered at the computer or through the use of computer equipment at remote locations. Therefore, in the absence of appropriate controls, there is an increased potential for unauthorized access to, and alteration of, data and programs by persons inside or outside the entity.

Design and Procedural Aspects : The development of CIS systems will generally result in design and procedural characteristics that are different from those found in manual systems. These different design and procedural aspects of CIS systems include:

a. *Consistency of performance*—CIS systems performed functions exactly as programmed and are potentially more reliable than manual systems, provided that all transaction types and conditions that could occur are anticipated and incorporated into the system. On the other hand, a computer program that is not correctly programmed and tested may consistently process transactions or other data erroneously.

b. *Programmed control procedures*—the nature of computer processing allows the design of internal control procedures in computer programs. These procedures can be designed to provide controls with limited visibility (e.g. protection of data against unauthorized access may be provided by passwords). Other procedures can be designed for use with manual intervention, such as review of reports printed for exception and error reporting, and reasonableness and limit checks of data.

c. *Single transaction update of multiple or data base computer files*—a single input to the accounting system may automatically update all records associated with the transaction (e.g. shipment of goods documents may update the sales and customers' accounts receivable files as well as the inventory file). Thus, an erroneous entry in such a system may create errors in various financial accounts.

d. *Systems generated transactions*—certain transactions may be initiated by the CIS system itself without the need for an input document. The authorization of such transactions may not be evidenced by visible input documentation nor documented in the same way as transactions which are initiated outside the CIS (e.g., interest may be calculated and charged automatically to customers' account balances on the basis of pre-authorized teams contained in a computer program).

e. *Vulnerability of data and program storage media*—large volumes of data and the computer programs used to process such data may be stored on portable or fixed storage media, such as magnetic disks and tapes. These media are vulnerable to theft, or intentional or accidental destruction.

4.13.2 Internal Controls in an CIS Environment

The internal controls over computer processing, which help to achieve the overall objectives of internal control, include both manual procedures and procedures designed into computer programs. Such manual and computer control procedures comprise the overall controls affecting the CIS environment (general CIS controls) and the specific controls over the accounting applications (CIS application controls).

General CIS *Controls :* The purpose of general CIS controls is to establish a framework of overall control over the CIS activities and to provide a reasonable level of assurance that the overall objectives of internal control are achieved. General CIS controls may include:

a. *Organization and management controls*—designed to establish an organizational framework over CIS activities, including:

- ✓ Policies and procedures relating to control functions.
- ✓ Appropriate segregation of incompatible functions (e.g. preparation of input transactions, programming and computer operations).

b. *Application systems development and maintenance controls*—designed to provide reasonable assurance that systems are developed and maintained in an authorized and efficient manner. They also typically are designed to establish control over:

- ✓ Testing, conversion, implementation and documentation of new or revised systems.
- ✓ Changes to application systems.
- ✓ Access to systems documentation.
- ✓ Acquisition of application systems from third parties.

c. *Computer operation controls*—designed to control the operation of the systems and to provide reasonable assurance that:

- ✓ The systems are used for authorized purposes only.
- ✓ Access to computer operations is restricted to authorized personnel.

- ✓ Only authorized programs are used.
- ✓ Processing errors are detected and corrected.

d. *Systems software controls*—designed to provide reasonable assurance that system software is acquired or developed in an authorized and efficient manner, including:

- ✓ Authorization, approval, testing, implementation and documentation of new systems software and systems software modifications.
- ✓ Restriction of access to systems software and documentation to authorized personnel.

e. *Data entry and program controls*—designed to provide reasonable assurance that:

- ✓ An authorization structure is established over transactions being entered into the system.
- ✓ Access to data and programs is restricted to authorized personnel.
- ✓ There are other CIS safeguards that contribute to the continuity of CIS processing. These may include:
- ✓ Offsite back-up of data and computer programs.
- ✓ Recovery procedures for use in the event of theft, loss or international or accidental destruction.
- ✓ Provision for offsite processing in the event of disaster.

CIS *Application Controls :* The purpose of CIS application controls is to establish specific control procedures over the accounting applications in order to provide reasonable assurance that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis. CIS application controls include:

A. *Controls over input*—designed to provide reasonable assurance that:

- ✓ Transactions are properly authorized before being processed by the computer.
- ✓ Transactions are accurately converted into machine readable form and recorded in the computer data files.
- ✓ Transactions are not lost, added, duplicated or improperly changed.
- ✓ Incorrect transactions are rejected, corrected and, if necessary, resubmitted on a timely basis.

B. *Controls over processing and computer data files*—designed to provide reasonable assurance that:

- ✓ Transactions, including system generated transactions, are properly processed by the computer.
- ✓ Transactions are not lost, added, duplicated or improperly changed.
- ✓ Processing errors are identified and corrected on a timely basis.

C. *Controls over output*—designed to provide reasonable assurance that:

- ✓ Results of processing are accurate.
- ✓ Access to output is restricted to authorized personnel.
- ✓ Output is provided to appropriate authorized personnel on a timely basis.

4.13.3 Review of Internal Controls

Review of General CIS *Controls* - The general CIS controls which the auditor may wish to test are described above. The auditor should consider how these general CIS controls affect the CIS applications significant to the audit. General CIS controls that relate to some or all applications are typically inter-dependent controls in their operation is often essential to the effectiveness of CIS application controls. Accordingly, it may be more efficient to review the design of the general controls before reviewing the application controls.

Review of CIS *Application Controls* - Control over input, processing, data files and output may be carried out by CIS personnel, by users of the system, by a separate control group, or may be programmed into application software, CIS application controls which the auditor may wish to test include:

A. *Manual controls exercised by the user*—if manual controls exercised by the user of the application system are capable of providing reasonable assurance that the systems' output is complete, accurate and authorized, the auditor may decide to limit tests of control to these manual controls (e.g. the manual controls exercised by the user over a computerized payroll system for salaried employees could include an anticipatory input control total for gross pay, the test checking of net salary output computations, the approval of the payments and transfer of funds, comparison to payroll register amounts, and prompt bank reconciliation). In this case, the auditor may wish to test only the manual controls exercised by the user.

B. *Controls over system output*—if, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, it may be possible to test such controls by examining the system's output using either manual or computer-assisted audit techniques. Such output may be in the form of magnetic media,, microfilm or printouts (e.g. the auditor may test controls exercised by the entity over the reconciliation of report totals to the general ledger control accounts and may perform manual tests of those reconciliations). Alternatively, where the reconciliation is performed by computer, the auditor may wish to test the reconciliation by reperforming the control with the use of computer-assisted audit techniques

C. *Programmed control procedures*—in the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output (e.g. in an application that does not provide printouts of critical approvals or overrides to normal policies, the auditor may want to test control procedures contained within the application program). The auditor may consider performing tests of control by using computer-assisted audit techniques, such as test data, reprocessing transactions data or, in unusual situations, examining the coding of the application program.

Evaluation - The general CIS controls may have a pervasive effect on the processing of transactions in application systems. If these controls are not effective, there may be a risk that misstatements might occur and go undetected in the application systems. Thus, weaknesses in general CIS controls may preclude testing certain CIS application controls; however, manual procedures exercised by users may provide effective control at the application level.

4.13.4 Approaches to Audit in CIS Environment

Changes in hardware and software, have changed the conceptual approach to auditing. An early approach consisted of essentially ignoring the computer, treating it as a black box, and auditing around it. The increasing sophistication of computers, however, has since led to computers being used in two ways; (1) as a tool of the auditor aiding in the performance of the audit, such as printing confirmation requests, and (2) as the target of the audit where data are submitted to the computer and the results are analyzed for processing reliability and accuracy of the computer program.

The auditor must plan whether to use the computer to assist the audit or whether or whether to audit without using the computer. The two approaches are commonly called "auditing around the computer" and "auditing through the computer".

The work of an auditor would be hardly affected if "Audit Trail" is maintained *i.e.* if it were still possible to relate, on a 'one-to-one' basis, the original input with the final output. A simplified representation of the documentation in a manually created audit trail.

From this Figure I the particular credit notes may be located by the auditor at any time he may wish to examine them, even months after the balance sheet date. He also has the means, should he so wish, of directly verifying the accuracy of the totals and sub-totals that feature in the control listing, by reference to individual credit notes. He can, of course, check all detailed calculations, casts and postings in the accounting records, at any time.

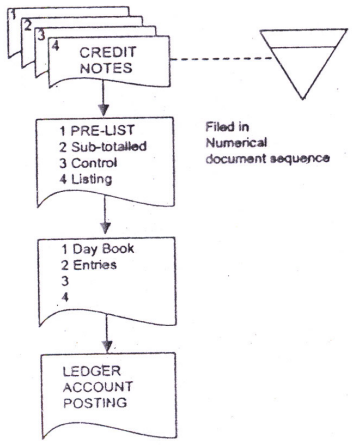


Diagram I Manually created audit trail

In first and early second-generation computer systems, such a complete audit trail was generally available, no doubt, to management's own healthy scepticism of what the new machine could be relied upon to achieve - an attitude obviously shared by the auditor. The documentation in such a trail might again be portrayed as shown, in an over-simplified way, in Figure I.

It is once again clear from the diagram that there is an abundance of documentation upon which the auditor can use his traditional symbols of scrutiny, in the form of coloured ticks and rubber stamps. Specifically :

1. The output itself is as complete and as detailed as in any manual system.
2. The trail, from beginning to end, is complete, so that all documents may be identified by locating for purposes of vouching, totalling and gross-referencing.

Any form of audit checking is possible, including depth testing in either direction.

The execution of normal audit tests on records which are produced by computer, but which are nevertheless as complete as indicated above, is usually described as audit testing round the machine.

Auditing around the Computer - Auditing around the computer involves arriving at an audit opinion through examining the internal control system for a computer installation and the input and output only for application systems. On the basis of the quality of the input and output of the application system, the auditor infers the quality of the processing carried out. Application system processing is not examined directly. The auditor views the computer as a black box.

The auditor can usually audit around the computer when either of the following situations applies to application systems existing in the installation:

1. The system is simple and batch oriented.
2. The system uses generalized software that is well-tested and used widely by many installations.

Sometimes batch computer systems are just an extension of manual systems. These systems have the following attributes:

1. The system logic is straightforward and there are no special routines resulting from the use of the computer to process data.
2. Input transactions are batched and control can be maintained through the normal methods, for example, separation of duties and management supervision.
3. Processing primarily consists of sorting the input data and updating the master file sequentially.
4. There is a clear audit trail and detailed reports are prepared at key processing points within the system.
5. The task environment is relatively constant and few stresses are placed on the system.

For these well-defined systems, generalized software packages often are available. For example, software vendors have developed payroll, accounts receivable, and accounts payable packages. If these packages are provided by a reputable vendor, have received widespread use, and appear error-free, the auditor may decide not to test directly the processing aspects of the system. The auditor must ensure, however, that the installation has not modified the package in any way and that adequate controls exist, to prevent unauthorized modification of the package.

Not all generalized software packages make application systems amenable to auditing around the computer. Some packages provide a set of generalized functions that still must be selected and combined to accomplish application system purposes. For example, database management system software may provide generalized update functions, but a high-level program still must be written to combine these functions in the required way. In this situation the auditor is less able to infer the quality of processing from simply examining the system's input and output.

The primary advantage of auditing around the computer is simplicity. Auditors having little technical knowledge of computers can be trained easily to perform the audit.

There are two major disadvantages to the approach. First, the type of computer system where it is applicable is very restricted. It should not be used for systems having any complexity in terms of size or type of processing. Second, the auditor cannot assess very well the likelihood of the system degrading if the environment changes. The auditor should be concerned with the ability of the system to cope with a changed environment. Systems can be designed and programs can be written in certain ways so that a change in the environment will not cause the system to process data incorrectly or for it to degrade quickly.

Auditing through the Computer - The auditor can use the computer to test: (*a*) the logic and controls existing within the system and (*b*) the records produced by the system. Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

There are several circumstances where auditing through the computer must be used:

1. The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.
2. Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
3. The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.
4. Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be

performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing the auditor also can assess the system's ability to cope with environment change.

The primary disadvantages of the approach are the high costs sometimes involved and the need for extensive technical expertise when systems are complex. However, these disadvantages are really spurious if auditing through the computer is the only viable method of carrying out the audit.

4.14 INTERNAL CHECK

Internal check has been defined by the Institute of Chartered Accountants of England and Wales as the "checks on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned. A system of internal check in accounting implies organisation of system of book keeping and arrangement of staff duties in such a manner that no one person can completely carry through a transaction and record every aspect thereof. The essential elements of a goods system of internal check are :

(i) Existence of checks on the day-to-day transaction.

(ii) Which operate continuously as a part of the routine system.

(iii) Whereby the work of each person is either proved independently or is made complementary to the work of another.

Its objective is to prevent and to bring about a speedy detection of frauds, wastes and errors. The system is based on the principle that when the performance of each individual in an organisation, normally and automatically, is checked by another, the chances of occurrence of errors, or their remaining undetected, are greatly reduced; also that, when two or more persons essentially must combine either to receive or to make a payment, there will be lesser possibility of a fraud being perpetrated by them.

For instance, let us consider the simple case of a trading concern. It would have a cashier to receive cash who also shall issue receipts. There would be separate persons to write the cash book and ledgers, the stores accounts would be maintained by the store-keeper, and so on; there would be thus a large number of functionaries. In such an organisation, for putting through a transaction of sale, first of all a bill would be prepared and the same

would be checked and authorised by the sales manager; afterwards the cashier would collect the sale price and finally the store-keeper would issue the goods, on being satisfied that each of the functionaries earlier to him had carried out his part of duties.

Such a division of responsibilities is made on the broad principle that persons having physical custody of assets should not have access to the books of account. Also apart from accounting control, periodically the physical and financial records of important assets should be reconciled.

The scope of the statutory or professional audit is limited by the both the cost and the time factors. Therefore, it is increasingly being recognised that for an audit to be effective, especially when the size of a concern is large, the existence of a system of internal check is essential. The auditor can rely on it and, on that consideration, reduce the extent of detailed checking to be carried out by him but only after he has checked its effectiveness by the application of procedural tests. It must, however, be added that in the event of any mistake or fraud being discovered subsequently in the area of accounts which the statutory auditor has accepted to be correct, he may be guilty of negligence regardless of the fact that he had tested the internal check in operation before he has accepted it to be correct.

4.14.1 General Considerations in Framing a System of Internal Check

(1) No single person should have an independent control over any important aspect of the business. All dealings and acts of every employee should, in the ordinary course, come under the review of another.

(2) The duties of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.

(3) Every member of the staff should be encouraged to go on leave at least once in a year. Experience has shown that frauds successfully concealed by employees are often unearthed when they are on leave.

(4) Persons having physical custody of assets must not be permitted to have access to the books of account.

(5) There should exist an accounting control in respect of each important class of assets; in addition, these should be periodically inspected so as to establish their physical condition.

(6) To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.

(7) A majority of business concerns now-a-days work according to some kind of budgetary control. It enables them to review from time to time the progress of their trading activities. Such business houses should have a separate staff for the collection of statistical figures which later on should be checked with the corresponding figures from the financial books. If wide discrepancies are observed, these should be reconciled.

(8) For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to several sections of the organisation. It may prove dangerous to depend exclusively on the stock section staff for these tasks, since they may be tempted to under or over-state the stock.

(9) The financial and administrative powers should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.

(10) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

(11) Accounting procedures should be reviewed periodically, for, even well-designed and carefully installed procedures, in course of time, cease to be effective.

Tutorial Note: Since verification of the internal check is an important function of an audit, it is recommended that students should study the nature and details of the audit forms of internal check and their application, on examining their operation in various business organisations, the accounts of which they have an opportunity to audit. Examiners often require students to define internal check and also to suggest the internal checks which would be applicable for one or more operations of a business or to explain the consequences which would result if the internal checks in respect of one or more operations did not exist. Before attempting such a question, it is advisable that the student should visualise the various processes through which each transaction would pass before it is recorded, comprehend the exact nature of documents on the basis of which the transaction would be recorded and the sequences in which the entries would be made in the books of account. Once this is done, it would be possible for him to suggest the appropriate internal checks that should be introduced or the consequences if they are not introduced provided the student has knowledge of the fundamentals of the subject, the channels through which the money and goods normally flow and the various stages at which a record of their movements is kept.

4.15 INTERNAL AUDIT

It is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. But internal audit must not be confused with internal check. Internal check consists of a set of rules or procedures that are part of the accounting system, introduced so as to ensure that accounts of a business shall be correctly maintained and the possibility of occurrence of frauds and errors eliminated. On the other hand, internal audit is a thorough examination of the accounting transactions as well as that of the system according to which these have been recorded, with a view to reassuring the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of the management. However, the routine process by which an internal audit is carried out are broadly the same as those followed for professional audit. But internal audit often differs in its scope and emphasis : it is more managerial than accounting; also its form is varied, depending on the size of the organisation. For instance, whereas a professional auditor is primarily concerned with the legality or validity of transactions entered into by a business, an internal auditor in addition is expected to ensure that the standards of economy and efficiency are being maintained. On that account, the internal auditor must ascertain that orders for the purchase of stock are placed only after inviting tenders, sales are effected at the highest ruling rates, standard procedures as regards requirement of staff are followed, losses in manufacturing process suffered during the period under review are not higher than those in the earlier periods and so on. He must further confirm that there has been no leakage of stocks or revenue, overpayment of expenditure or pilferage or misappropriation of stocks or of any other asset, reconciling the physical accounting records and physical balance. The nature and extent of checking, that he should carry out, also would depend on the size and type of the business organisation.

"Internal Audit is an independent management function, which involves a continuous and critical appraisal of the functioning of an entity with a view to suggest improvements thereto and add value to and strengthen the overall governance mechanism of the entity, including the entity's risk management and internal control system."

The objects of internal audit can be stated as follows:

(1) To verify the accuracy and authenticity of the financial accounting and statistical records presented to the management.

(2) To ascertain that the standard accounting practices, as have been decided to be followed by the organisation, are being adhered to.

(3) To establish that there is a proper authority for every acquisition, retirement and disposal of assets.

(4) To confirm that liabilities have been incurred only for the legitimate activities of the organisation.

(5) To analyse and improve the system of internal check ; in particular to see (*i*) that it is working ; (*ii*) that it is sound ; and (*iii*) that it is economical.

(6) To facilitate the prevention and detection of frauds.

(7) To examine the protection afforded to assets and the uses to which they are put.

(8) To make special investigations for management.

(9) To provide a channel whereby new ideas can be brought to the attention of management.

(10) To review the operation of the overall internal control system and to bring material departures and non-compliances to the notice of the appropriate level of management ; the review also generally aims at locating unnecessary and weak controls for making the entire control system effective and economical.

As per SA-610 the scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity and the requirements of its management.

Normally, however, internal audit operates in one or more of the following areas :

(a) *Review of accounting system and related internal controls* : The establishment of an adequate accounting system and related controls is the responsibility of management which demands proper attention on a continuous basis. The internal audit function is often assigned specific responsibility by management for reviewing the accounting system and related internal controls, monitoring their operation and recommending improvements thereto.

(b) *Examination for management of financial and operating information* : This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.

(c) *Examination of the economy, efficiency and effectiveness of operations including non-financial controls of an organisation* : Generally, the external auditor is interested in the results of such audit work only when it has an important bearing on the reliability of the financial records.

(d) *Physical examination and verification* : The would generally include examination and verification of physical existence and condition of the tangible assets of the entity.

It is also worthwhile to know the modern concept of internal auditing. The Institute of Internal Auditors, USA defined internal auditing "as an independent appraisal function, established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed". According to proponents of modern internal auditing, it embraces not only the operational audit of various operating activities in the organisation but also includes the audit of management itself. Recently, the Institute of Internal Auditors revised the definition of Internal Auditing as under:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance process."

The main thrust of the revised definition is to remphasise the increasing scope of internal audit with a view to achieving maximum organisational effectiveness. It is felt that if such an activity is an integral part of the organisation, it shall go a long way to maximise the organisational goals. As students, if you trace the emergence of internal auditing over a period of time since early forties in the twentieth century, the scope of internal auditing increased considerably from financial to non financial activities. With the passage of time, the internal audit came to be recognised as a valuable resource to achieve overall growth objectives of the organisation.

To be effective, the internal auditor must be regarded as part of the management and not merely as an assistant thereto. He must have authority to investigate from the financial angles, every phase of the organisational activity under any circumstances. In recent years, there has been a growing tendency in Western countries to make the internal auditor responsible directly to the Board of Directors for the maintenance of adequate accounting procedures and for the preparation of financial statements and reports as regards the functioning of the business. His main responsibility, however, must be to maintain adequate system of internal control by a continuous examination of accounting procedures, receipts and disbursements and to provide adequate safeguards against misappropriation of assets. In carrying out these functions, he must operate independently of the accounting staff and must not in any way divest himself of any of the

responsibilities placed upon him. He should also not involve himself in the performance of executive functions in order that his objective outlook does not get obscured by the creation of vested interest.

It may be further pointed out that internal auditors who are qualified accountants, because of their training and experience, can be of great assistance to the management even in fields other than accounting. They can observe facts and situations and bring them to notice of authorities who would otherwise never know them ; also, they critically appraise various policies of the management and draws its attention to any deficiencies, wherever these require to be corrected. In order that an internal auditor may be able to play such a role in the field of management, he must be closely associated with it and his knowledge must be kept up to date by his being kept informed about all important occurrences and events affecting the business, as well as the changes that are made in business policies. Also, he must enjoy an independent status.

4.16 RELATIONSHIP BETWEEN THE STATUTORY AND THE INTERNAL AUDITORS

The function of an internal auditor being an integral part of the system of internal control, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor. As a matter of information, the students may note that under the Companies (Auditors Report) Order, 2003 issued under section 227(4A) of the Companies Act, the statutory auditor is required to comment (as amended by in Nov., 2004)on the internal audit system. For the purpose, he should examine the organisation of the Internal Audit Department, the strength of the internal audit staff, their qualification and their powers. Afterwards the procedures should be studied ; also the scope of the audit examination carried out should be ascertained on referring to audit programmes, reports submitted, points raised in audit and how these had been dealt with subsequently. The extent of independence exhibited by the internal auditor in the discharge of his duties and his status in the organisation are important factors for determining the effectiveness of his audit. In a large business, it has been increasingly recognised that, if their functions and those of statutory auditors could be integrated, it might not be necessary for the statutory auditors to go over the same facts and figure as have been previously examined by a competent and trustworthy internal audit staff. But so far, the practice of audit being conducted jointly by the internal auditors are of great assistance to statutory auditors.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he often decides to curtail his audit programme by dispensing with some of the detailed checking already carried out by the

Internal Audit Department after or without testing the work already done. He, at times, also decides to entrust certain items of work to the internal auditor. Given below are items of audit work in regard to which the statutory auditor accepts the checking that has already been carried out by the internal auditor ;

(i) Verification of the system of internal control ;

(ii) Verification of assets, e.g., stock in trade, fixed assets, book debts, etc. ; and

(iii) Verification of amounts provided for expenses as well as amounts adjusted as prepaid expenses.

It must however be mentioned that the area of co-operation between the statutory and the internal auditor is limited by the fact that the statutory auditor and the internal auditor owe their allegiance to separate authorities, the shareholders in one case and the management in the other. Therefore, the former is not protected against the liability for negligence which may arise in such a case.

4.16.1 General Evaluation of Internal Audit Function

The external auditor's general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. The external auditor should document his evaluation and conclusions in this respect. The important aspects to be considered in this context are :

(a) *Organisational Status* : Whether internal audit is undertaken by an outside agency or by an internal audit department within the entity itself, the internal auditor reports to the management. In an ideal situation he reports to the highest level of management and is free of any other operating responsibility. Any constraints or restrictions placed upon his work by management should be carefully evaluated. In particular, the internal auditor should be free to communicate fully with the external auditor.

(b) *Scope of Function* : The external auditor should ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for management. He should also ascertain to what extent the management considers, and where appropriate, acts upon internal audit recommendations.

(c) *Technical Competence* : The external auditor should ascertain that internal audit work is performed by persons having adequate technical training and proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.

(d) *Due Professional Care* : The external auditor should ascertain whether internal audit work appears to be properly planned, supervised, reviewed and documented. An

example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes, and working papers.

4.16.2 Coordination

Having decided in principle that the external auditor intends to rely upon the work of the internal auditor, it is desirable that the external auditor ascertains the internal auditor's tentative plan for the year and discusses it with him at as early a stage as possible to determine areas where he considers that he could rely upon the internal auditor's work. Where internal audit work is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to plan in advance the timing of such work, the extent of audit coverage, test levels and proposed methods of sample selection, documentation of the work performed, and review and reporting procedures.

Coordination with the internal auditor is usually more effective when meetings are held at appropriate intervals during the year. It is desirable that the external auditor is advised of, and has access to, relevant internal audit reports and in addition is kept informed, along with management, of any significant matter that comes to the internal auditor's attention and which he believes may affect the work of the external auditor. Similarly, the external auditor should ordinarily inform the internal auditor of any significant matters which may affect his work.

Where, following the general evaluation the external auditor intends to rely upon specific internal audit work as a basis for modifying the nature, timing and extent of his procedures, he should review the internal auditor's work, taking into account the following factors :

(a) The scope of work and related audit programmes are adequate for the external auditor's purpose.

(b) The work was properly planned and the work of assistants was properly supervised, reviewed and documented.

(c) Sufficient appropriate evidence was obtained to afford a reasonable basis for the conclusions reached.

(d) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.

(e) Any exceptions or unusual matters disclosed by the internal auditor's procedures have been properly resolved.

The external auditor should document his conclusions in respect of the specific work which he has reviewed.

The external auditor should also test the work of the internal auditor on which he intends to rely. The nature, timing and extent of the external auditor's tests will depend upon his judgement as to the materiality of the area concerned to the financial statements taken as a whole and the results of his evaluation of the internal audit function and of the specific internal audit work. His tests may include examination of items already examined by the internal auditor, examination of other similar items, and observation of the internal auditor's procedures.

4.16.3 Requirements of CARO, 2003

Clause 4(vii) of CARO, 2003 requires the auditor to comment whether the company has an internal audit system commensurate with the size and nature of the business. The clause is required to be commented upon by the auditor in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. This clause has a mandatory application for the listed companies irrespective of the size of paid-up capital and reserves or turnover. It may be noted that the Order does not specify the date with reference to which the listing status of the company should be determined. In this regard, it is clarified that if the company is listed on a recognised stock exchange as on the date of the balance sheet, it should be considered as listed for the purpose of this clause. In respect of non-listed companies the clause is applicable only if:

(i) the paid-up capital and reserves of the company are more than rupees fifty lakhs as at the commencement of the financial year; or

(ii) average annual turnover exceeds rupees five crores for a period of three consecutive financial years immediately preceding the financial year concerned.

In other words, companies which have a paid-up capital and reserves of rupees fifty lakhs or less as at the commencement of the financial year as well as the companies which have an average annual turnover of rupees five crores or less for a period of three consecutive financial years immediately preceding the financial year concerned are excluded from the applicability of the clause. A company may either have its own internal audit department or entrust the work of internal audit to an outside agency. In the case of a group of concerns, it is also quite common to have a central internal audit department.

The arrangement which is more suitable will depend upon the circumstances of each company but generally, where a company is small, it may find it expensive to have its own internal audit department staffed by personnel having the requisite qualifications. The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:

(i) What is the size of the internal audit department?

(ii) What are the qualifications of the persons who undertake the internal audit work?

(iii) To whom does the internal auditor report?

(iv) What are the areas covered by the internal audit?

(v) Has the internal auditor adequate technical assistance?

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work?

(vii) What is the follow-up?

It is important to note that the Companies Act, 1956 does not require a company to necessarily have an internal audit system. However, where such a system does not exist, the Order requires the auditor to mention the fact in his report. Moreover, since this part of the Order refers only to such companies which are either listed or companies having a paid-up capital and reserves in excess of rupees 50 lakhs or an average annual turnover in excess of rupees 5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, it is desirable that such a company has an internal audit system. It is equally important to note that the internal audit system is a part of the overall internal control system. Therefore, the scope of the internal audit and the extent of its coverage will, to some extent, depend upon the existence or otherwise of other forms of internal control. This is also a factor to be considered when evaluating the adequacy of the internal audit system.

APPENDICES

INTERNAL CONTROL QUESTIONNAIRES

Extract from Internal Control Questionnaire published by the Institute of Chartered Accountants of India (Note : Columns Yes, No, N.A. and Explanatory Notes have been omitted here)

I - Purchases and Creditors

1. Are purchases centralised in the Purchase Department ?
2. (a) Are purchases made only from approved suppliers ?
   (b) Is a list of approved suppliers maintained for this purpose ?
   (c) Does the master list contain more than one source of supply for all important materials ?
3. Are the purchase orders based on valid purchase requisitions duly signed by persons authorised in this behalf ?
4. (a) Are purchases made on behalf of employees ?
   (b) If so, is the same procedures followed for other purchases ?
5. Is special approval required for :
   (a) Purchase from employees, directors and companies in which directors are interested ?
   (b) Purchases of capital goods ?
6. Are purchases based on competitive quotations from two or more suppliers ?
7. Is comparative quotation analysis sheet drawn before purchases are authorised ?
8. If the lowest quotation is not accepted, is the purchase approved by senior official?
9. If the price variation clauses is included, is it approved by a senior official ?
10. Are purchase orders pre-numbered and strict control exercised over unused forms?
11. Are purchase orders signed only by employees authorised in this behalf ?
12. Do purchase orders contain the following minimum information :
    (*a*) Name of supplier ? (*b*) Delivery terms ?
    (*c*) Quantity ? (*d*) Price ?
    (*e*) Freight terms ? (*f*) Payment terms ?
13. Is revision of terms of purchase orders duly authorised ?

14. (a) Are copies of purchase orders and revisions forwarded to Accountants and Receiving Departments ?

    (b) If 'Yes', do the copies show the quantities ordered ?

    (c) If 'no', is there an adequate procedure for the Receiving Dept., to be notified to accept deliveries ?

15. Is a list of pending purchase orders compiled by the Purchase Dept., at least once every quarter ?

16. Are all materials, suppliers, etc., received only in the Receiving Department?

17. If they are received directly by User Department/Processors/Customers, is there a procedure of obtaining acknowledgments for the quantity received and the condition of the goods ?

18. Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices ?

19. Are materials, suppliers, etc., inspected and counted, weighed or measured in the Receiving Department ?

20. Are quantities and description checked against purchase order (or other form of notifications) and goods inspected for condition ?

21. (a) Does the Receiving Dept. deliver or supervise the delivery of each item received to the proper Stores or Department Location ?

    (b) Are acknowledgments obtained from suppliers for goods/containers returned to them ?

22. Are all receipts of materials evidenced by pre-numbered Goods Received Note ?

23. Are copies of Goods Received Notes forwarded to Accounts Department and list of goods received to purchase department ?

24. Are all cases of materials returned, shortages and rejections advised to the Accounts Department, for raising Debit Memoes on suppliers or claim bills on carriers/insurance companies, as the case may be ?

25. Are all debit notes etc.

    (a) pre-numbered ?

    (b) numerically controlled ?

    (c) properly recorded (in the financial accounts or in memorandum registers as the case may be) ?

26. (a) Are all suppliers' invoices routed direct to the Accounts Department ?

    (b) Are they entered in a Bill Register before submitting them to other department for check and/or approval ?

    (c) Are advance and partial payments entered on the invoices before they are submitted to other departments ?

27. Does the system ensure that all invoices and credit notes are duly processed ?

28. In respect of raw materials and supplies, are reconciliations made of quantities and/or values received, as shown by purchase invoices with receipts into stock records?

29. Are duplicate invoices marked immediately on receipt to avoid payment against them ?

30. If payment are made against duplicate invoice even occasionally, are adequate precautions taken to avoid duplicate payments ?

31. Does the Accounts Department match the invoices of supplies with Goods Received Notes or acknowledgments received as per Q 17 and purchase orders ?

32. (a) Are Goods Received Notes and Receiving records regularly received for items for which no invoices have been received ?

    (b) Are all such items investigated and is provision made for the liability in respect of such items?

    (c) In such review/investigation done by persons independent of those responsible for the receipt and control of goods ?

33. Do all invoices bear evidence of being checked for prices, freight terms, extensions and additions?

34. Is the relative purchase order attached to the invoice for payment ?

35. Where the client both buys from and sells to a person regularly, is a periodic review made of all amounts due from that person to determine whether any set-off is necessary?

36. (a) Is a special request used for making payments in advance or against documents through bank ?

    (b) Thereafter, are the invoices made in the normal course ?

37. (a) Are all advance payments duly authorised by persons competent to authorise such payments?

    (b) Is a list of pending advances made at least every quarter and is a proper follow-up maintained ?

38. Are all adjustments to creditors accounts duly approved by those authorised in this behalf?
39. Is a list of employees by designation with limits of authority in respect of several matters referred to in this section maintained ?
40. Are all supplier's statements compared with ledger account ?
41. Is there any follow-up action to investigate difference, if any between the suppliers' statements and the ledger accounts?
42. Is a list of unpaid creditors prepared and reconciled periodically with the General Ledger Control Account ?
43. Is there a system of ensuring that cash discounts are availed of whenever offered?

II - Sales and Debtors

1. Are standard price lists maintained ?
2. Are prices which are not based on standard price lists, required to be approved by a senior executive outside the State Department ?
3. Are written orders from customers received in all cases ?
4. If oral/telephonic orders are received, are they recorded immediately in the client's standard forms?
5. Is there a numerical control of all customer's orders ?
6. Are credit limits fixed in respect of individual customers ?
7. Are these limits approved by an official independent of the Sales Department?
8. Are credit limits reviewed periodically ?
9. Are customers' credit limits checked before orders are accepted ?
10. Is this done by a person independent of the Sales Department ?
11. If sales to employees are made at concessional prices :
    (a) Is there a limit to the value of such sales ?
    (b) Is there an adequate procedure to see that these limits are not exceeded ?
    (c) Are the amounts recovered in accordance with the terms of sale ?
12. Are despatches of goods authorised only by Despatch Notes/Gate Passes or similar documents ?
13. Do such Despatch Notes/Gate Passes or similar documents bear pre-printed numbers ?
14. Are they under numerical control ?

15. Are they prepared by a person independent of :
    (a) the Sales Department ?
    (b) the processing of invoices ?
16. Except when all documents are prepared in one operation, are the Despatch Notes/ Gate Passes matched with :
    (a) Excise Duty records ?
    (b) Sales invoices ?
    (c) Freight payable to carriers (where applicable) ?
17. Are unmatched Despatch Notes/Gate Passes reviewed periodically ?
18. Are the goods actually despatched checked independently with the Despatch Notes/Gate Passes and Customer's Orders ?
19. Are acknowledgments obtained form the customers for the goods delivered ?
20. Are the customers' orders marked for goods delivered ?
21. Are shortages in goods delivered to the Customers investigated ?
22. Are credits to customers for shortages, breakages and losses in transit matched with claims lodged against carriers/insurers ?
23. Are sales invoices pre-numbered ?
24. Are all invoice numbers accounted for ?
25. Are invoices checked for :
    (a) prices ?
    (b) calculations (including excise duty and sales tax) ?
    (c) terms of payment ?
26. Are 'no charge' invoices authorised by a person independent of the custody of goods or cash ?
27. Are invoices mailed direct to the customers promptly ?
28. Are credits to customers for remittances posted only from the entries in the cash book (or equivalent record) ?
29. Does cashier notify immediately :
    (a) Sales Department,
    (b) Debtors' Ledger Section and

(c) Credit Controller;

(i) of all dishonoured cheques or other negotiable instruments ?

(ii) of all documents sent though band but not retired by the customers ?

30. Is immediate follow up action taken on such notification ?

31. Are bills of exchange (or other negotiable instruments) accepted by customers recorded?

32. Are the bills of exchange, etc. as per such record periodically verified with the bills on hand?

33. (a) Is a record of customers' claims maintained ?

(b) Are such claims properly dealt with in the accounts ?

34. Does the Receiving Department count, weigh or measure the goods returned by customers ?

35. Does the Receiving Department record them on a Sales Returns Note ?

36. Are copies of Sales Returns Notes sent to :

(a) Customer ? (b) Sales Department ? (c) Debtors Ledger Section ?

37. Are the returned goods taken into stock immediately ?

38. Is a Credit Note issued to the customer for the goods returned ?

39. Are all Credit Notes pre-numbered ?

40. Are Credit Notes numerically controlled ?

41. Are Credit Notes authorised by a person independent of :

(a) Custody of goods ? (b) Cash receipts ? (c) Debtors' Ledger ?

42. Are Credit Notes :

(a) compared with Sales Returns Notes or other substantiating evidence ?

(b) checked for prices ?

(c) checked for calculations ?

43. Are corresponding recoveries of sales commissions made when Credit Notes are issued to customers ?

44. Are units of sales (as per sales invoices) correlated and reconciled with the purchases (or production) and stocks on hand ?

45. Is the Sales Ledger balanced periodically and tallied with the General Control Account ?

46. Are ageing schedules prepared periodically ?
47. Are they reviewed by a responsible person ?
48. Are statements of accounts regularly sent to all customers ?
49. Are the statements checked with the Debtors' Ledger before they are issued ?
50. Are the statements mailed by a person independent of the ledger keeper ?
51. Are confirmations of balances obtain periodically ?
52. Are the confirmations verified by a person independent of the ledger-keeper and the person preparing the statement ?
53. Is special approval required for :
    (a) payments of customers' credit balances ?
    (b) writing off bad debts ?
54. Is any accounting control kept for bad debts written off ?
55. Is any follow up action taken for recovering amounts written off ?
56. In the case of export sales :
    (a) Is a record maintained of import entitlements due ?
    (b) Does the record cover the utilisation disposal of such entitlements ?
    (c) Is there a procedure to ensure that claims for incentives etc., receivable are made in time ?
57. Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods ?

III - Stocks

1. Are stocks stored in assigned areas ?
2. If so, is access to these areas limited ?
3. Are stocks insured against the following risks :
    (a) fire ? (b) strike, riot and civil commotion ?
    (c) flood ? (d) hail damage where applicable ?
4. If the answer to any of the above is negative, is it due to specific decision taken by a senior official?
5. Is a record maintained for the insurance polices ?
6. Is the record reviewed periodically ?

7. Is there an official who decides on the value for which the stocks are to be insured?
8. Is the adequacy of the insurance cover reviewed periodically ?
9. Are perpetual stock records kept for :
   (a) raw materials ? (b) work-in-progress ?
   (c) finished goods ? (d) stores ?
10. Are they periodically reconciled with accounting records ?
11. Is there a system of perpetual inventory for stocks of :
   (a) raw materials ? (b) work-in-progress ?
   (c) finished goods ? (d) stores ?
12. Where there is a system of perpetual inventory count :
   (a) Is there a periodical report of shortages/excess ?
   (b) If so, are these differences investigated ?
   (c) Are these differences adjusted in the stock records and in the financial accounts ?
   (d) Is written approval obtained from a responsible official to adjust these differences ?
13. Are there norms for stock levels to be held ?
14. Is there a periodic reporting of :
   (a) Slow-moving items ? (b) Damaged items ?
   (c) Obsolete items ? (d) Over-stocked items ?
15. Is there a well-laid out written procedure for inventory count ?
16. (a) Are stocks physically verified once in a year ?
   (b) Is this done by a person independent of persons who are responsible for maintaining these records or the storekeeper ?
   (c) Are written instructions prepared for guidance of employees engaged in physical stock taking to cover :
      (i) Proper identification and arrangement of stocks ?
      (ii) Cut-off points of receipts and deliveries ?
      (iii) Recording of the condition of the stocks ?
      (iv) Compliance with the conditions warranties in the relative insurance policies ?

17. Are the physical inventory records, such as tags, cards, tally sheets, under numerical control?
18. Are the clerical steps in the preparation of stock sheets checked independently for:
    (a) Summarisation of quantities ? (b) Unit rates ?
    (c) Additions ? (d) Extensions ?
    (e) Unit conversions ? (f) Summarisation of cards and/or sheets?
19. Are the quantities shown in the stock sheets compared with the quantities declared to banks or insurers, where possible ?
20. If there are significant variations between the actual stocks and book stocks :
    (a) Are they investigated ?
    (b) Is a recount made where necessary ?
    (c) Is the stock book corrected with proper authority ?
21. Are the following stocks checked :
    (1) Physically by the company's staff ?
    (2) With certificates from concerned holders of the stocks ?
        (a) Stock in public warehouses ?
        (b) Stocks with consignees ?
        (c) Stocks with sub-contractors for fabrication, etc. ?
        (d) Stocks with customers, on approval ?
        (e) Stocks in bonded warehouses ?
        (f) Stocks pledged with third parties ?
22. Is stock on hand relating to third parties, such as customer's stocks and consignments physically segregated or properly identified ?
23. Are the procedures relating to record keeping and stock-taking made applicable to third also?
24. Are confirmations obtained from the third parties for stocks held on their behalf ?
25. Are records maintained for :
    (a) Scrap available for sale ?
    (b) By-products ?
    (c) Returnable containers ?

26. Is there an adequate recording procedure for :
    (a) Stocks with outsides ?
    (b) Stocks of outsiders held by the company ?
27. Is there a system of job/production orders for control of production ?
28. Does the storekeeper issue raw materials, stores etc., only against Requisition Notes signed by properly authorised officials ?
29. Does the storekeeper acknowledge in writing the quantity of finished goods received from the Factory ?
30. Is the stock record periodically checked with such acknowledgments ?
31. Does the cost system provide for obtaining units or job order costs for :
    (a) Work-in-progress ?
    (b) Finished goods ?
32. Is the cost system integrated with/or reconciled to General Ledger controls as regards :
    (i) Material ? (ii) Labour ?
    (iii) Overheads ?
33. Does the cost system provide for detailed units or job order costs in terms of :
    (i) Raw material costs ? (ii) Direct labour ?
    (iii) Overheads ? (iv) Physical quantities ?
    (v) Unit rates ?
34. Are similar records kept for service departments also ?
35. Are overhead rates :
    (a) Reviewed periodically by designated employees ?
    (b) Adjusted in the light of current experience ?
36. Are separate control accounts maintained for stock of :
    (a) Work-in-progress ? (b) Finished goods ?
37. In a job order industry, are the estimates of costs compared with actual costs ?
38. If standard cost system exists :
    (i) Are variances investigated ?
    (ii) Are standards reviewed periodically ?

IV. Cash and Bank Receipts

1. Is inward mail opened by persons not connected with handling cash or the Accounts Department?
2. Is the inward mail date stamped?
3. Is there a detailed record of receipts prepared?
4. Are all cheques specially crossed by employees opening mail?
5. Are bank deposits prepared and made by some one other than those responsible for cash receipts and/or personal ledger?
6. Are duplicate (or counterfoils of) receipted deposit slips received from the bank?
7. Is there any comparison of items listed on the duplicate (or counterfoils of) deposit slips with the amounts of cheques recorded in the cash receipts records?
8. Are receipts given for over-the-counter collections"
9. Is the reconciliation of such proofs of collection with amounts banked?
10. Are collections of branch offices and sales offices deposited in special bank accounts, subject to withdrawal only by the Head Office?
11. If collections are made by representatives of the company in cash, have serially numbered receipts been issued to them?
12. Is there a system of issuing permanent receipts in lieu of the Temporary/Provisional receipts issued by bill collectors, etc.?
13. Are such collections promptly received and banked?
14. Are the receipt forms :
    (a) serially numbered?
    (b) kept in safe custody?
    (c) controlled by register?
    (d) unused stocks checked regularly?
    (e) made out by one employee and despatched by another?
    (f) accounted for, including those cancelled?
    (f) in respect of partially used receipt books not intended to be used, cancelled?
15. Are cancelled receipts preserved ?
16. If post-dated cheques are received, are they held in safe custody until deposited?

17. Are such cheques entered in a separate register?
18. Is the opening of bank accounts authorised by the Board of Directors?
19. Are sundry items, such as dividends, interest, rent, commissions, etc. regularly checked by responsible official to satisfy himself that correct amounts are received?
20. Is there a procedure to ensure that Hundi borrowings are only by cheques crossed "Accounts Payee"?
21. Is the cash balance verified frequently?
22. Incoming money orders, VPP receipts etc. :
    (a) Are they signed by any official other than the cashier?
    (b) Are they listed immediately?
    (c) Are such lists compared with the Cash Book regularly?
    (d) Is there an arrangement with the Postal authorities to receive cheques instead of cash?
23. Are the cashier's duties taken over for a few days, by some one else, occasionally?
24. If a rough cash book is maintained :
    (a) Is the fair cash book written up promptly?
    (b) Is the fair cash book checked with the rough cash book, by a person other than the cashier?

V. Cash and Bank Payments

1. Does the company's policy prohibit disbursements directly from cash receipts?
2. Are all disbursements made by cheques?
3. Are the names of officials and the limits upto which they are authorised to sign cheques, specified?
4. Are all cheques payable 'to order" and crossed 'Account Payee Only" except cheques for wages and petty cash?
5. Are cheque protectors used?
6. Are unused cheques under proper physical control?
7. Are cancelled cheques mutilated?
8. Is the practice of signing cheques in blank, prohibited?
9. Are payments made only against original invoices (or equivalent documents?

10. Are cheques accompanied by vouchers when presented for signature?
11. Do vouchers contain evidence of examination by persons signing cheques and/or those authorising vouchers for payment?
12. Is the accounting distribution on the voucher checked at the time of payment?
13. Are all supporting documents properly defaced and identified by cheque number at the time of signature?
14. Is there a method to check if cheques are despatched immediately?
15. Are remittances by bank transfers or letters of instructions (*e.g.,* TTs, MTs, standing instructions) subject to the same controls as cheque payments?
16. Is there an effective system in force for following up receipts from payees and filling complete vouchers?
17. When "stop-payment" instructions are issued, are the original entries reversed immediately?
18. Is there a schedule of dates in each month for the recurring payments such as P.F., Tax deducted at source. Telephone bills, Electricity bills. etc.?
19. In respect of bills accepted?
    (a) is there a record of such bills?
    (b) are they signed by official authorised to do so?
20. Are bank loans or overdrafts (including temporary overdrafts) arranged only by officials authorised by the Board?

VI. Fixed Assets

Purchases and Disposal

1. Are budgets for capital expenditure approved by the Board?
2. Are approved budgets communicated in writing to :
    (a) Purchase Department?
    (b) Accounts Department?
    (c) Department originating the request?
3. Are written authorisations required for incurring capital expenditure for items included in the Budget?
4. Is the authority to incur capital expenditure restricted to specified officials?

5. Are purchases of capital items subject to same controls as are applicable to purchases of raw materials, stores, etc.?
6. Are receipts of capital items subject to same procedures as applicable to raw materials, stores, etc.?
7. Is there proper check to see that amounts expended do not exceed the amount authorised?
8. Are supplemental authorities required for excess expenditures?
9. Is there any established procedure for moving plant and machinery from one location to another?
10. (i) Is written authority required for :
    (a) scrapping fixed assets?
    (b) selling fixed assets?
    (ii) Is the authority to permit scrapping/selling of fixed assets restricted to specified officials?
    (iii) Are limits specified in this regard?
    (iv) Are sales of fixed assets subject to same procedures as are applicable to sales of finished goods?
11. Are reports issued promptly in respect of :
    (a) units sold?
    (b) units scrapped?
    (c) units moved from one location to another?

Records :

12. Are fixed assets under construction :
    (a) subject to separate control account in General Ledger?
    (b) controlled by job number?
13. Is expenditure on wages, materials and stores charged to capital account on reasonable basis?
14. Is there any official responsible for ensuring that allocation of expenditure between capital and revenue is in accordance with the company's accounting policy?
15. Is a register of all fixed assets (including fully depreciated assets) maintained?
16. Is the register regularly written up throughout the year?

17. Is the register periodically tallied with the financial accounts?
18. Is the following information available, in the register?
    (a) Supplier's name
    (b) Date of purchase
    (c) Cost (including additions, improvements, exchange rate adjustments etc.)
    (d) Location and identification number
    (e) Rate of depreciation and estimated life
    (f) Accumulated depreciation
    (g) Estimated salvage value
19. Is a record maintained of equipment used by the company, but owned by others?
20. Is the register of patents or trade marks maintained up-to-date?
21. Is there a list of title deeds for the landed properties and buildings?
22. Are title deeds of properties kept in safe place?
23. If they are lodged as security, are certificates obtained to that effect periodically?
24. Are registration books of vehicles periodically verified?

Verification :

25. Are fixed assets verified periodically?
26. Is there a written procedure for such verification?
27. Does the procedure provide for verification/confirmation of fixed assets with third parties?
28. Does the procedure provide for verification of compliance with the warranties and conditions in the relevant insurance policies?
29. Are reports prepared on such verification?
30. Do such reports indicate damaged/obsolete items of fixed assets?
31. (*a*) Are discrepancies disclosed by such reports investigated?
    (b) Are the records and financial accounts corrected, with proper authority?
32. Are damaged/obsolete items disclosed by such reports, removed from the records and financial accounts with proper authority?

Moulds, Patterns, Jigs, Fixtures, Tools etc.

33. Is there satisfactory control over the acquisition and write-off of such items?
34. Are there physical safeguards against theft or loss of tools and other movable equipment?
35. Are records maintained for :
    (a) items treated as stock?
    (b) items treated as fixed assets?

Insurance :

36. (i) Are the following risks covered in respect of buildings and machinery :
        (a) Fire
        (b) Strike, riot and civil commotion
        (c) Flood
        (d) Earthquake
        (e) Nuclear risks
        (f) Malicious damage
        (g) War risks
    (ii) If the answer to any of the above is negative, is it due to a specific decision taken by a senior official?
37. Is there an adequate procedure to ensure that assets acquired between two renewal dates are also covered by insurance?
38. Is there an official who decides on the value for which policies are taken?
39. Are the fixed assets insured at re-instatement basis?
40. Does the official, who decides on the value for which policies are taken, review periodically the adequacy of the insurance cover?
41. (i) Is there loss-of-profits insurance cover?
    (ii) Is there machinery-breakdown insurance cover?
    (iii) If the answer to (i) or (ii) is negative is it due to a specific decision taken by a senior official?

VII. Bank Balances

1. Are bank statements opened by a person other than the person signing cheques, recording cash and receiving or disbursing?
2. Are the bank accounts reconciled at regular intervals?
3. Is Bank reconciliation statement drawn by a person independent of cash receipt and disbursement function?
4. Does the reconciler compare each item in the deposit and withdrawal columns of the bank statement with amount deposited or withdrawn as shown by the cash records both as regards date and amount?
5. Is there a periodic follow-up of old :
   (i) outstanding deposits?
   (ii) outstanding payments?
   (iii) outstanding stop-payment advices?
6. Are the items under reconciliation reviewed by a responsible official promptly or upon completion?
7. Are confirmations of balances obtained periodically in respect of all bank balances and compared with the bank statements?
8. Is there a periodic review of balances held as security, for letters of Credit, Guarantees, etc., to ensure the need for their continuance?
9. Are Fixed Deposit Receipts held in safe custody?
10. Is there a register of Fixed Deposits showing maturity dates, rates of interest and dates for payment of interest?
11. Is there a follow-up system to ensure that interest on Fixed Deposits is received on due dates?
12. Is a Certificate obtained from the bank for Deposit Receipts lodged as security?

Self-Examination Questions

1. Analyse the following situations and consider whether the internal control in operation is sound :

   (i) A company's manual provides for payments exceeding Rs. 1,000 to be paid by cheque. The cheque is to be signed by the accountant and the managing director. The managing director is often out on tours and, to facilitate the payment being made timely, puts blank signature on the cheques so that the accountant can sign and make the payment. According to the manual, both the signing authorities have to examine the party's invoice, goods received note and the inspection report before signing the cheques.

   (ii) The cashier of a concern receives and opens the daily inward mail. The cheques and postal orders are immediately listed by the cashier and rest of the mail is marked to appropriate officials. He prepares a statement of the cheques and postal orders being deposited in the five banks with which the concern maintains account. In the receiving cash book he enters the aggregate of the amount sent to each bank and the cash collection is entered under the cash column. He also maintains a petty cash. The copy of the list is sent to the sales ledger section for being posted to the concerned accounts.

   (iii) All goods are ordered by the Purchase Officer upon the request of various departmental heads. When the goods are received, the receiving clerk prepares a receiving report in triplicate, one copy is sent to the Purchase Section, one copy to the department needing the goods and the remaining copy is retained by the receiving clerk. Invoice received are forwarded to the accounts department to ensure payment within the period of credit. After payment, two copies of the invoice are sent to the Purchase Section for comparison with the purchase order and the receiving report and one copy is returned after necessary comparison to the accounts department for being tagged to the original invoice.

   (No Payment invoice should be compared with the goods received note before payment.)

   (iv) The travelling salesmen are provided with printed books for booking of orders. No record of the books is kept. The folios in the books are not pre-numbered though each book is supposed to contain 50 folios. One copy of the sales book is forwarded

to the sales section and the other copy to the accounts section for calculating the commission payable. The cancelled folios along with all copies they are required to remain intact in the book itself. Five such books are issued to each salesman at a time. However, on the return from each visit the salesman deposits the book which is used up with the sales section. On an average a salesman needs 100 books in a year.

2. What are important features of a good system of internal control ?

3. Discuss the relative merits and demerits of the various methods used for collection of information about the existence and state of internal control.

4. Existence and operation of a good system of internal control can reduce the auditors workload to a considerable extent. State how the auditor can being about this reduction.

5. (a) What is internal audit ?

   (b) Distinguish between 'internal control and internal audit'.

   (c) The modern concept of internal audit envisages scope of internal audit much beyond financial audit. Discuss.

   (d) 'The statutory auditor is entitled to rely on the internal auditor'. Comment.

6. Explain the term 'Internal Check'. In what way does it affect the work of the statutory auditor?

7. Suggest a set of rules you would recommend for the internal control over the purchases of raw materials and stores of a large manufacturing concern.

8. (a) Distinguish between Internal Audit and Statutory Audit.

   (b) Can the statutory auditor rely upon the internal audit in carrying out his function as a statutory auditor?

   (c) State briefly what are the matters now to be included in the Auditor's Report in respect of the internal audit system of a large manufacturing company.

9. On being appointed the auditor of a company for the first time you find that the cashier also handles the books of account and the cash receipt are not being banked intact but parts of these are being utilised for cash payments

What would be your reaction? What recommendations would you make to the company in this connection ?.

10. A large foundry engaged in production of ferrous materials accumulates periodically considerable quantity of scrap some of which has high re-sale value.

    Draft a suitable internal control system by which the company may exercise control over this item.

11. (a) What is meant by the term 'Internal Control?

    (b) Draft a form of questionnaire which you would use for determining the effectiveness of the client's internal control over payrolls.

    (c) To what extent can you rely upon the efficiency of an internal audit system to reduce your area of checking the income transactions of your client company?

12. (a) Explain the nature and purpose of 'auditing in depth'.

    (b) List the points that would be covered in auditing in depth of the payment of wages in a large stone quarry. The quarry is spread over an area of 15 sq. kms. The total number of labourers are about 8,000, out of which 2,000 are paid on piece-rate basis and the rest on daily basis.

13. (a) What are the objectives of Internal Audit?

    (b) Discuss the relationship between internal audit and statutory audit?

14. (a) Distinguish briefly Internal check, Internal audit and Internal control.

    (b) Discuss briefly the general considerations in framing a system of internal control in respect of purchases of goods.

15. For evaluating the accounting system, the techniques of flow charting and procedural tests are useful. Comment.

16. What are the aims of internal control so far as financial and accounting aspects are concerned?

17. (a) "The statutory auditor is entitled to rely on the internal auditor.'

    (b) "The statutory auditor should test internal control before relying on the same."

    Comment on the above statements.

18. Discuss briefly the features of an effective system of internal control over wages and salaries in a large factory.

19. What is Internal Audit? Describe the basic principles of establishing internal auditing in a business concern.

20. "The concept of Balance sheet audit has been developed alongwith the development of formal Internal Control System". Describe briefly what a Balance Sheet audit approach will include.

21. Prepare an Internal Control Questionnaire for raw material purchase in a multi-product engineering company.

22. You have been appointed as Internal Auditor of a company and you have come across certain weaknesses in the internal control system. Draft a specimen form of Management Letter indicating at least four areas of weaknesses relating to Internal Control.

23. (a) What precautions are to be taken in the application of test-checking techniques?

    (b) Mention any of the four items which are not suitable for test-checking.

Multiple Choice Questions

1. Which of the following statements is not distinguishing denature for computer based processing and manual processing ?

   (a) Errors in a CIS environment are less systemic as compared to errors in manual processing

   (b) The potential for human error in the CIS environment is greater as compared to manual system

   (c) In a computer based accounting system, audit trail is in electronic form

   (d) Computer processing officers management a variety of analytical tools.

2. To avoid invalid data input, a bank added an extra number at the end of each account number and subjected the new number to an algorithm. This technique is known as

   (a) Dual read

   (b) Test for reasonableness

(c) Check Digit

(d) Occurrence correction

3. When computer programme or files can be accessed from terminals, access can be limited to authorised individuals by --

(a) Appointing a librarian

(b) controlling passwords

(c) Appointing EDP auditor

(d) Both (a) and (b)

4. Which of the following has not been paired correctly ?

(a) Record Counts

(b) Hash totals

(c) Occurrence correction

(d) Personal identification code

5. Occurrence correction is an input control —

(a) Control

(b) Processing Control

(c) Input Control

(d) Processing Control

6. Erroneous data has been detected by computer programme controls. It has been excluded from processing and printed separately as "Error Report". Who should most probably review and follow up on this report ?

(a) System analyst

(b) data control group

(c) Programmer

(d) Computer operator

7. General controls will be ineffective when EDP department —

   (a) Anticipates in computer software acquisition decisions.

   (b) Design documentation for computerised operations.

   (c) Originate changes in master files.

   (d) Provide physical security for programme files.

8. EDP department should neither authorise nor initiate any transaction. Which of the following activates would most likely be performed by EDP department ?

   (a) Authorising transaction

   (b) Parity checks

   (c) Distributing output

   (d) Correction of transactional errors

9. The completeness of 'wages' figure can be tested by comparing the number of time cards to be processed with transactions on wage sheet. This type of control technique is called

   (a) Check digits

   (b) Control total

   (c) Occurrence Correction

   (d) Check Digit

10. Which of following will not affect audit in a CIS environment ?

   (a) The objective of expression of opinion on financial statements

   (b) Compliance procedures adopted by the auditor

   (c) Performance of substantive procedures

   (d) Evaluation of inherent risk and control risk

11. As per AAS-29, the Auditor should document —

    (a) The audit plan;

    (b) The Audit Procedures;

    (c) The audit conclusions

    (d) All of them

12. The title of AAS-29 is --

    (a) Auditing of EDP control

    (b) Auditing is a computerised Information system environment

    (c) Auditing in EDP Environment

    (d) Auditing is a Computer Information System Environment

13. Which of the following statement is not true of the test data approach in a test of computerised accounting system ?

    (a) Test data tests only those controls which the auditor wishes to rely

    (b) Test data should consist of data related to all controls prevalent in the organization

    (c) The result of test data indicates that all the application and general controls are functioning properly

    (d) Test data are processed by the client's computer programme under the auditor's control

14. Which of the following CAATs allow fictions transactions planted by the auditor to be processed along with real ones on client's system ?

    (a) Integrated test facility

    (b) Test data approach

    (c) Generalise auditing software

    (d) Parallel simulation

15. Which of following is not true about GAS ?

    (a) It helps to select a sample of items and evaluate sample results

    (b) Data Can be compared on separate files with its help

    (c) It assists the auditor in performing compliance and substantive tests

    (d) The auditor of a small entity should prepare data or create performance only after assessing

16. An auditor is least likely to use computer software to --

    (a) Access client data files

    (b) Access control risk

    (c) Performing analytical Producers

    (d) None of the above

CHAPTER 5

VOUCHING

Learning Objectives

After studying this chapter, you will be able to -

- Gain knowledge on vouching of cash and trade transactions.
- Understand types of accounts and various procedures of vouch of each account specifically.
- Prepare the bank reconciliation statement.

The act of examining vouchers is referred to as vouching. It is the practice followed in an audit, with the objective of establishing the authenticity of the transactions recorded in the primary books of account. It essentially consists of verifying a transaction recorded in the books of account with the relevant documentary evidence and the authority on the basis of which the entry has been made; also confirming that the amount mentioned in the voucher has been posted to an appropriate account which would disclose the nature of the transaction on its inclusion in the final statements of account. On these considerations, the essential points to be borne in mind while examining a voucher are:

(i) that the date of the voucher falls within the accounting period;

(ii) that the voucher is made out in the client's name;

(iii) that the voucher is duly authorised;

(iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and

(v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

5.1 AUDIT OF CASH TRANSACTIONS

5.1.1 General Considerations

In any business probably cash transactions account for the largest bulk of transactions. Cash, being a highly liquid asset, is exposed to frauds of various types. Therefore, it is essential for an auditor to satisfy himself that the cash transactions entered into by the client have been correctly recorded in the books of account and all the procedures laid down for entering into such transactions have been complied with.

To verify cash transactions, more than anything else, it is necessary that the system of accounting and internal control operating in the organisation should be reviewed; also the recording of each transaction should be checked. It should also be seen that each relevant voucher has documentary evidence which is valid and that the statement is authorised by a competent official. Further, on its inclusion in the final accounts, its nature would be truly disclosed.

(i) *Internal Control System* : It is a combination of several procedures adopted by an entity designed:

(a) to give protection against losses through fraud, waste, mistakes, etc.,

(b) to ensure that the transactions entered into shall be correctly recorded; and

(c) to enable the concern to take policy decision as regards planning and operation of the business at the appropriate time.

Steps involved in the verification of the system of Internal Control :

(a) Study the system according to which accounting routines are being carried out to ensure that these do not leave any receipt of cash, material or any other asset remaining unaccounted for, permit any payment of money being made without relevant goods or services having been received or tendered or any property being given away without its price having been received or being accounted for.

(b) Examine the financial power vested in different persons and the conditions under which they can exercise them.

(c) Confirm whether the supervision over various managerial and accounting functions, exercised by different members of the staff to whom these duties have been assigned, is adequate.

(d) Ascertain whether any mechanical aids are being employed to ensure proper accounting of receipts and prevention of pilferage of cash, stamps, etc.

(e) Observe the working of the accounting system and routine and determine, by application of procedural tests, whether checks and counter-checks envisaged by the system of internal control are being properly applied.

(f) Confirm that there is a system according to which the physical existence of different forms of assets is being periodically reconciled with their balances in the books of account or stores records and discrepancies noticed are reported and adjusted; also that balance of customers, creditors, bankers and persons with whom securities are deposited are reconciled periodically. Further, that persons who are in custody of valuable assets, have furnished bonds of adequate value which would protect the company in the event of any misappropriation or misapplication thereof by such persons.

(g) Ascertain that the system of internal control is reviewed periodically and, where necessary, a change in procedures made to plug in any loopholes which might have been observed on such a review. Also, that policy decisions which are taken from time to time are translated into actual practice.

Students should remember that, unless the system of internal control is comprehensive it may fail to provide the protection expected of it. For example, if printed receipts with counterfoils are issued in respect of amounts collected, but there is no check against cash being collected by unauthorised persons, there will be no certainty that all amounts collected have been accounted for.

(ii) *Correctness of book-keeping records* : The audit of cash transactions entails detailed checking of the record of transactions for verifying that entries have been made in the books of account according to the system of accounting which is being regularly followed and the books of account balance as under :

(a) Vouching;

(b) Posting;

(c) Casting, cross-casting and tracing; and

(d) Reconciliation, scrutiny, confirmation, etc.

When accounts are checked in the foregoing manner, they may disclose one or more mistakes or manipulations in the accounts of different types stated below.

✓ Errors of omission or commission which are accidental, e.g., failure to enter some sales invoices, mistakes made in computing amounts payable for purchase, etc.

✓ Cases of deliberate omission or commission:

- to cover up a defalcation of cash, e.g., amount received from A having been posted to the account of B and subsequently, the amount paid by B having been misappropriated; or
- to overstate profit or assets, e.g., no provision having been made for outstanding liabilities or the goods already sold before the close of the year having been included in closing stock;
- to overstate liabilities and understate assets, with a view to providing a basis for effecting fictitious payments in the former case and misappropriation of the sale proceeds in the latter case.
- Errors of principle such as revenue expenditure having been charged to capital.
- Compensation errors, e.g., "Furniture Account", having been undercast by Rs. 100 and "Repairs Account" overcast by the same amount.

(iii) *Observance of accounting principles* : It is of utmost importance that the transactions should be recorded in the books of accounts having regard to the principles of accounting. The principles include :

(a) Distinction being drawn between capital expenditure and revenue expenditure;

(b) Distinction being drawn between capital receipts and revenue receipts;

(c) The expenses or cost should be matched to the income or benefit;

(d) The expenditure and income should be treated on accrual basis;

(e) That the fixed assets should be depreciated on a consistent basis;

(f) That book debts should be valued only at realisable amounts;

(g) That fictitious assets are written off at the earliest; and

(h) Outstanding assets and liabilities have been properly adjusted.

(iv) *Evidence of Transactions* : Entries in the account books are usually made on the basis of some kind of documentary evidence. It generally exists in a variety of forms e.g., payee's receipts, suppliers' invoices, statements of account of parties, minutes of Board of Directors or of the shareholders, contracts, documents of title, entries in subsidiary ledger,etc. The process of verification of entries in the books of account with the documentary evidence is referred to as vouching. As stated earlier, documentary evidence is of two types : (1) Internal; and (2) External. Documents which are part of the records of the concern, and have been prepared in the normal processes of accounting constitutes internal evidence, e.g., counterfoils of receipts, carbon copies of cash memos or invoices, wages books, etc. On the other hand, a document issued by a person with whom some business transaction had been entered into or who paid or was advanced an

amount constitutes external evidence, e.g., a payee's receipt, an invoice for purchases, a court decree, a lease agreement, a bank statement, etc. because these documents are issued by persons not belonging to the concern. External evidence, in respect of certain transactions, sometimes may have to be obtained directly by the auditors, e.g., certificate as regards bank balances, or confirmation balances of debtors and creditors, etc.

The auditor, obviously, should endeavour in the course of his examination to get as much external evidence as possible since such evidence ordinarily provides confirmation. When, however, it is not possible to obtain external evidence and he is obliged to accept internal evidence, he should first satisfy himself on a careful consideration of the position whether the evidence which has been produced to him, can be reasonably assumed to have come into existence in the normal course of working of the business and that there exists a system of internal check which would act as a safeguard against its being altered subsequently.

External evidence should be preferred, since the likelihood of its being duplicated or fabricated is much less. This is because it requires collusion with an outsider which, normally is not practicable. However, every evidence 'whether internal or external' should be subjected to appropriate scrutiny and corroboration should be obtained, if possible. The auditor will always keep in mind the circumstances of the case and see whether the evidence is *prima facie* authentic and correct.

Note : Students should observe carefully in the course of their practical training, the various forms in which documentary evidence usually exists in support of different types of transactions and also the sources from which further evidence can be mustered because it is more re-assuring to verify a transaction from two or more sources which are mutually independent.

(v) *Validity of Transactions* : It is also the function of audit to establish that payments have been made validly to persons who are shown to be recipients. For example, it must be verified that salaries to partners were paid according to a provision contained in the partnership deed and the directors fees were paid according to the provisions in that regard in the Articles of Association or the resolution passed by members of the company at a general meeting. For checking the validity of a transaction, it is usually necessary to refer to documentary evidence. It may exist in any of the following forms.

- ✓ The legal provisions, if any, having bearing on the accounts of the entity under audit.
- ✓ The rules or regulations governing the internal working of the organisation, e.g., the Articles of Association, Partnership Deed, Trust Deed, etc.
- ✓ Minutes of the proceedings of a meeting of members of the company , that of the directors or that of the Managing committee

- ✓ Copy of an agreement, e.g., Managing Director's agreement, Lease Deed, vendor's agreement, agency agreement, contract with an employee, etc.

An auditor should have a clear and precise knowledge of legal provisions under which the concern was registered or is functioning, as well as those which constitutes the basis of various transactions entered into, more particularly the provisions as regards maintenance and audit of its accounts. He should also study the rules, if any, framed for regulating the internal management of the entity; these may be embodied in some of the documents mentioned above. If he has any doubt on any legal point, by way of guidance, he should call for legal opinion. However, unless he is convinced of the reasonableness of the legal opinion, he should not act on it. In the case of *Republic of Bolivia Exploration Syndicate Ltd.* [1914], it was held that auditors are *prima facie* responsible for *ultra vires* payments made on the faith of their balance sheet but whether, and to what extent, they are considered responsible for not having discovered them in their audit would depend upon the circumstances of each case. An auditor is responsible for detecting payments that are *ultra vires* the company (*Leed Estate Building & Investment Society v. Shepherd).*

(vi) *Disclosure in the Final Accounts* : The object of audit ultimately is that the statements of account prepared from books of account which have been checked should present a true and fair picture of the financial position of the entity. This particular objective should be kept in view while checking the grouping of accounts. The auditor must see that not only items of a like nature be grouped together but also the description of each account truly reflects the nature of the amounts accumulated therein. Unless this is verified, the classification of income and expenditure and that of assets and liabilities would be misleading. For example if director's fee and salaries to staff have been added together or advances to directors have been covered up by being amalgamated with book debts, the nature of these payments would be obscured. Fundamentally, care should be taken to ensure that no material fact is suppressed or stated in a manner that it may mislead any one. If it is found that owing to costing or managerial requirements, certain items of expenditure or receipts have not been classified by the company in the way as would meet the requirements of the Companies Act, 1956 the client's staff at the end of the year should be required to re-classify them. Nevertheless such a re-classification of expenditure should be checked by the assistant of the auditor to confirm that it has been correctly made and that no item requiring re-classification has been left out. In the case of a company, Schedule IV to the Companies Act, 1956 has laid down requirements in regard to the disclosure.

5.1.2 Casting or Totalling

Sometimes the totals of a wage bill are inflated by over totalling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from customers by under-totalling the receipts column of the cash book. At times, shortages in cash have been also covered up by over totalling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked. On these considerations, where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced. This would deter him from altering the totals on the totaling mistakes being discovered.

Sometimes a fraud is committed in the following manner :

(a) undercasting the receipt side of the cash book;

(b) overcasting the payment side of the cash;

(c) fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;

(d) posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and

(e) wrong totals or balances being carried forward in the cash book or in the ledger.

Students, it is expected, will be able to think several other devices where amounts can be misappropriated either by making wrong entries or by failing to make an entry in the accounts.

5.1.3 Bank Reconciliation Statement

Bank reconciliation is an important accounting control. It is expected the students will be familiar with the method of preparing Bank Reconciliation Statement, as described in the text book. A copy of the statement duly signed by the accountant of the client after it has been checked, should be kept in record by the auditor along with other working papers, for future reference. The position of cheques and other remittances shown in the statement as outstanding should be ascertained on a reference to the Bank Pass Book. Where it is found that a number of cheques have been deposited in the bank immediately before the close of the year, which subsequently were dishonoured, it should be investigated whether these were fictitious which had been deposited merely to inflate the bank balance or to show parties' balances outstanding against whom were infact

irrecoverable. Generally, it is advisable that the position of all amounts deposited in the bank, which were outstanding for realisation at the close of the year, should be ascertained.

5.2 AUDIT OF PAYMENTS

Under the Indian Stamp Act, 1899, instruments whereby payment is acknowledged, should bear a revenue stamp. An auditor, therefore,should see that the receipts produced in evidence of payments, shown to have been made are properly stamped. The date of issue of a stamp paper from the stamp office is entered on its back. The design on revenue stamp also is changed from time to time. Such information sometimes may provide a clue leading to the discovery that a receipt has been forged or agreement has been ante-dated. It is the practice with some big companies to have a receipt form printed on the back of their cheques, so that the endorsement on the cheque may be accepted as an evidence of payment. Such cheque forms are specially printed by the bank under an agreement with the customer. The system has a drawback from the point of view of the auditor in so far as that such a receipt is only an evidence of the fact that the amount has been paid by the bank; but not that of the identity of the party to whom the payment is purported to have been made. As a safeguard, the auditor should see that adequate precautions to prevent payments being made to wrong persons were being taken by the client's office (One precaution could be that all cheque forms should have "Account payee only" printed on them). It would also be advisable for him to refer other connected documents, viz., invoices, debit notes, etc. against which payments have been made before accepting such receipts as evidence of payment of money. In such cases, the auditor would be well advised to obtain confirmation of balances of personal accounts and, wherever practicable, these should be obtained directly by him.

5.2.1 Purchase of Goods

Cash purchases should be verified by reference to cash memos or receipted invoices by suppliers. Payments made against credit purchases should be vouched with the receipts issued by the suppliers and the credit to their accounts on the basis of invoices entered in the Purchases Day book. There must be also evidence of the goods having been received through an entry in the Goods Inward Books or stock ledger.

It is necessary, however, to make a distinction between a payment for goods and an advance against supplies to be made in future; the latter should be classified as advance recoverable in cash or in kind or for value to be received. Since the amount shown as an

advance paid against goods may be only a camouflage for an assistance to a party, it is necessary for the auditor to confirm that the advance was paid pursuant to a normal trade practice and supplies were, subsequently, received with a reasonable period of the advance.

Certain concerns issue invoices in duplicate. In such a case, there can be a possibility of an invoice being paid twice; first by its being entered in the Purchase Day Book and the account of the supplier being credited and the second time by the duplicate copy of the invoice being paid as a cash purchase. On this account, on noticing a receipted invoice, the auditor should verify that neither the original nor the duplicate thereof has been already entered in the Purchase Day Book. In the case of goods purchased at the end of year, it should be further verified that even though not received or entered in stock before the close of the year, they have been included in the closing stock. To confirm that all the goods, payment for which have been made, have been received and entered in stock, all invoices for purchases made during one week preceding the close of the year should be traced into the Goods Received Book maintained by the Receiving Section, also it should be verified that every purchase invoice is stamped with the date of receipt of goods in stock and the ledger folio at which invoice has been entered.

For a more detailed discussion on vouching of credit purchases, students may refer to Audit of Trading Transactions.

5.2.2 Transactions with Directors

A director of a company or his relative, a firm in which a director or his relative is a partner or a private company of which the Director is a member, cannot enter into any contract with the company for sale, or purchase or supply of goods and materials or for underwriting subscriptions to shares or debentures except with the consent of the Board. Such a consent can be given only by a resolution at a Board Meeting passed before the contract is entered into or within three months thereof. In case of companies having a paid up capital of Rs. one crore or more in addition to the Board's consent prior approval of Central Government would be necessary. There are certain exceptions to this rule which are contained in sub-section (2) of Section 297 of the Companies Act, 1956. A contract in contravention of this provision can be avoided by the Board at its option.

Further, every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement entered into or one proposed to be entered into by the company, must disclose his interest to the company at the Board Meeting (Section 299). An interested director is also restrained from taking part in the

discussion of or voting of any contract or arrangement in which he is interested nor can his presence count for the purpose of forming the quorum required for considering such a contract for voting thereat. If he does so, his vote would be invalid. There are certain exceptions to these provisions contained in sub-sections (2) and (3) of Section 300. Similarly, for transaction with certain parties in which directors are interested, it is necessary to ensure that the prices are reasonable having regard to the prevailing market prices vide Companies (Auditor's Report) Order, 2003 as amended by the Amendment Order, 2004.

5.2.3 Remuneration paid to Directors

The following points must be considered while vouching the directors' remuneration in case of a public company and private company which is a subsidiary of a public company–

(i) *Examine the Entitlement*: The directors are not automatically entitled to remuneration. It is paid either according to the term of articles of association or in accordance with a resolution of the general meeting.

(ii) *Examine Adherence to Legal Provisions*: The auditor should examine adherence to relevant sections of the Act such as –

- ✓ Section 309(3) and (4) which deals with manner of payment of managerial remuneration.
- ✓ Section 309(2) which deals with payment of listing fees.
- ✓ Section 198 which has prescribed the overall limit to managerial remuneration.
- ✓ Schedule XIII to the Act that has laid down conditions for payment of remuneration for companies having profits those having no profits or inadequate profits and companies having negative effective capital.
- ✓ Section 310 which provides for increase in remuneration.

5.2.4 Payment for Acquisition of Assets

The purchase of an asset must be duly supported by the receipt for the amount paid. In case of an immovable property the auditor must also inspect the title deeds. The title of an immovable property passes only on registration. It is therefore essential for an auditor to see that property has been registered in the purchaser's name as required by the Transfer of Property Act, 1882 and also that the title of the transfer to sell property has been verified by a solicitor or an advocate.

In the case of movable property requiring registration of ownership, e.g., a car or a ship, it must be verified that such a registration has been made in favour of the purchaser. It is necessary for the auditor to satisfy himself generally as regards *existence, value and title* of the assets acquired. It must also be verified that the assets were purchased only by a person who had the authority to do so. Section 292 of the Companies act, 1956 provides that only the Board of Directors can invest the funds of the company. Thus the Board alone can sanction the purchase of a fixed asset. If the benefit of an item of expense has been acquired by the purchaser along with the asset, its value should be debited to a separate account, e.g., when a motor car has been purchased on which certain taxes and insurance charges were paid by the seller for a period that had not expired. In the case of an asset constructed or manufactured by the client himself, e.g., where a building has been constructed or a plant or machinery manufactured by the concern with its labour and materials, it must be verified that the cost of labour, materials and other direct expenses incurred has been charged as cost of the asset on a proper allocation of the total expenditure debited under these heads. This is because, if a larger sum is capitalised than warranted in the circumstances, it would inflate the profit and if a smaller amount is debited, it would have the effect of unduly reducing the profit. Also corresponding values of assets would not be properly recorded. It must also be seen that neither expenses on repairs and maintenance have been capitalised nor the cost of additions to assets charged off as revenue expenses.

5.2.5 Payments controlled by the Companies Act, 1956

(a) Under sub-section (1A) of section 227 Clause (e) requires personal expenses charged to the revenue account of a company should be reported.

(b) Under section 293, the Board of Directors of a public company or of a private company which is a subsidiary of a public company, shall not, except with the consent of such public company or subsidiary in general meeting.

  (i) Sell, lease or otherwise dispose of the whole, or substantially the whole of the undertaking of the company, or where the company owns more than one undertaking, of the whole, or substantially the whole, of any such undertaking;

  (ii) remit, or give time for the re-payment of, any debt due by a directors (except in the case of renewal or continuance of an advance made by a banking company to its director in the ordinary course of business);

  (iii) invest, otherwise than in trust securities, (the amount of compensation received by the company in respect of the compulsory acquisition, after the commencement of this Act), of any such undertaking as is referred to in clause (a), or of any premises

or properties used for any such undertaking and without which it cannot be carried on or can be carried on only with difficulty or only after a considerable time ;

(iv) borrow monies where the amount borrowed together with monies already borrowed by the company apart from the temporary loans obtained from the company's bankers in the ordinary course of business, exceeds the aggregate of the paid up capital of the company and its free reserves ; and

(v) contribute amounts to charitable and other funds, not related to the business of the company or the welfare of the employees, the aggregate whereof exceeds in a financial year Rs. 50,000 or 5% of the average net profit, during the three financial years immediately preceding, whichever is greater.

(c) Section 293A deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three years cannot contribute any amount directly or indirectly to any political party or for any political purpose to any person. In other cases, contribution should not exceed 5% of average net profits in any financial year determined in accordance with the provision of section 349 and 350 during the three immediately preceding financial years.

(d) Section 293B permits the Board and other person to make contributions to the National Defence Fund to any extent as it thinks fit.

5.2.6 Assets acquired on Hire Purchase Basis

Where a movable asset, such as motor car or machinery has been acquired on a hire-purchase basis, it should preferably be adjusted in accounts at its cash value by raising a liability for the amount payable to the financing company ; also the interest payable along with each instalment, whether separately or included therein should be debited to the interest account.

Payments under a hire purchase agreement should be vouched having regard to the conditions contained therein, as well as on a consideration of the manner in which amounts paid have been adjusted, *e.g.,* the amount paid as a penalty for late payment of instalments should be debited as an expense instead of being added to the cost of the assets.

5.2.7 Assets Acquired on Lease

Considering the requirement of AS 19, "Lease", which classify transaction into (a) finance lease or (b) operating lease. In case of operating lease, lease payment should be recognised as an expense in the Statement of Profit and Loss on a straight-line basis over

the lease term. Whereas in case of finance lease, all the substantial risks and rewards incidental to ownership are transferred thus, considering the indication as prescribed in AS 19, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. The lease agreement has to be studied and nature of agreement will decide the treatment of the lease payments.

5.2.8 Payment of Expenses

Normally, every item of expenditure has to be written off in the year in which it is incurred. But, considering the requirement of AS 10 and AS 26, the expenses relating to tangible and intangible assets can be capitalized if recognition criteria are met. It may be noted that with the issuance of AS 26, "Intangible Assets", the concept of deferred revenue expenditure is no more in existence.

If the provision for outstanding expenses made in a past year turns out to be insufficient and the amount is material, proper disclosure of such a fact should be made in the accounts of the year in which any further amount is charged on that account. This is done either by showing the amount separately in the inner column and explaining its nature or by including it in the Appropriation Section of the Profit and Loss Account.

Only expenses incurred for the purpose or for the benefit of business are chargeable to it. The auditor therefore, should make certain, as far as practicable, that no personal expenses are charged to the business. In the case of a company, as has been stated earlier, personal expenses, if charged, have to be reported, particularly those which are not covered by commercial practices or contractual obligation.

It should be verified that all expenses incurred, whether paid or payable, have been included in the accounts and that where any part of an item of expenses relates to the period that extends beyond the close of the year, a proportionate amount thereof has been adjusted as prepaid expense.

Where some of the expenses are found to have been adjusted in a lump-sum specially at the close of the year, these might be fictitious items introduced merely to reduce profits. These, therefore, should receive special attention of the auditor.

5.2.9 Payment of Taxes

Payment on account of income-tax and other taxes consequent upon a regular assessment should be verified by reference to the copy of the assessment order, as-

sessment form, notice of demand and the receipted challan. Payments or advance payments of income-tax should also be verified with the notice of demand and the receipted challan acknowledging the amount paid. The interest allowed on advance payments of income-tax should be included as income and penal interest charged for non-payment should be debited to the interest account.

5.2.10 Customs and Excise Duties

The audit procedures for custom duties are listed below:

(i) *Examine Cash Book*: Examine the payment of custom duties in the cash book with reference to bill of entry.

(ii) *Examine the Bill of Entry*:

- ✓ Check the amount of custom duty was calculated correctly, i.e., in accordance with the applicable rate for dutiable goods.
- ✓ If the duty has been paid by dealing and forwarding agent, examine bill of entry with reference to agent's bill.
- ✓ If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of customs duty.

(iii) *Examine Disputed Cases Carefully*: In case of a dispute about the amount of duty payable, a provisional payment may have been made. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.

(iv) *Verify for Duty Drawback*: Duty drawback refers to a scheme under which central excise and customs duties paid for raw-materials and other inputs used in the manufacture of the product prior to its export are refunded to the exporter. The auditor should verify the claim of duty drawback with reference to acknowledgement issued by the Directorate of duty drawback.

Excise duty becomes payable at the time of releasing at excisable goods from the factory/godown to the manufacturer. Normally, the excise duty payable is deposited with the designated bank to the credit of the controller of excise and one copy of the challan is forwarded to him for obtaining the permit and another copy is sent to the dispatch department evidencing payment of required duty. The auditor may adopt the following procedures to vouch the payment of excise duties:

(i) Verify payment of excise duties by examining the duly paid as per challans with reference to the quantity of goods in respect of which issue permits have been received.

(ii) Test check the accuracy of the amount of duty paid by multiplying the rate of excise duty with the value of goods issued as per the client's stock register.

(iii) In respect of excisable goods manufactured but remaining to be released, ensure that necessary provision for unpaid excise duty has been made.

(iv) Ensure that in every case CENVAT credit has been adjusted and only net excise duty has been paid.

5.2.11 Travelling Expenses

Travelling expenses are normally payable to staff according to rules approved by directors or partners. Where no rules exist, the auditor should recommend that these be framed for controlling the expenditure. In the absence of T.A. Rules, the expenditure should be vouched on the basis of actual expenditure incurred. A voucher should be demanded for all items of expenses incurred, except those which are capable of independent verification.

As regards travelling expenses claimed by directors the auditor should satisfy himself that these were incurred by them in the interest of the business and that the directors were entitled to receive the amount from the business.

The voucher for travelling expenses should normally contain the undermentioned information :

(i) Name and designation of the person claiming the amount.

(ii) Particulars of the journey.

(iii) Amount of railway or air fare.

(iv) Amount of boarding or lodging expenses or daily allowance along with the dates and times of arrival and departure from each station.

(v) Other expenses claimed, e.g., porterage, tips, conveyance, etc.

If the journey was undertaken by air, the counterfoil of the air ticket should be attached to the voucher ; this should be inspected. For travel by rail or road, the amount of the fare claimed should be checked from some independent source. Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified. The evidence in regard to sundry expenses claimed is generally not attached to T.A. bills. So long as the amount appears to be reasonable it is usually not questioned. All vouchers for travelling expenses should be authorised by some responsible official. In the case of foreign travel or any extraordinary travel, the expenses, before being paid, should be

sanctioned by the Board. The travelling advance taken, if any should be settled on receipt of final bills. At the year, the amount not settled should be shown appropriately in the Balance Sheet.

Unless the articles specifically provide or their payment has been authorised by a resolution of shareholders, directors are not entitled to charge travelling expenses for attending Board Meetings.

5.2.12 Repairs to Assets

Since the line demarcating repairs from renewals is slender, usually it is not a simple matter to determine the amount of the expenditure, if any, included as charges for repairs, which should be considered as that incurred for renewal of an asset and added to its cost. It may sometimes be possible to determine this on a consideration of the nature of repairs carried out. The proportion of the charges which had the effect of increasing the value of an asset or enhancing its capacity or life, should be treated as capital expenditure. Where, however, it is not possible to form an opinion accurately on the basis of evidence as regards the nature of repairs, a certificate from the engineer under whose supervision the repairs were carried out, confirming the classification of expenditure should be obtained.

5.2.13 Preliminary Expenses

The expenditure incidental to the creation and floating of a company includes stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc. The contracts relating to preliminary expenses should be examined. If preliminary expenses incurred by promoters have been reimbursed to them by the company, the resolution of the Board of Directors and the power in the Articles to make such re-imbursement should be seen. The bills and statements supporting each item of preliminary expenses should be checked. It should be seen that no expenses other than those which constitutes preliminary expenses are booked under this head. The auditor can cross check the amount of preliminary expenses with that disclosed in the prospectus, statutory report and the balance sheet. Any amount paid in excess of the amount disclosed in the prospectus should have been approved by the shareholders. Expenditure in connection with the preliminary expenses so far it has not been written-off should be separately disclosed under the head miscellaneous expenditure. Underwriting commission and brokerage paid for shares and debentures should not be included under the head preliminary expenses.

5.2.14 Salaries and Wages

Payments on account of salaries and wages need to be vouched carefully, since amounts which were either not due or in excess of those due may have been paid by the client. The evidence in support of such payments generally is internal. It can, therefore, be relied upon only if it has been produced in the normal course of business and there exists an efficient system of internal control which could be expected to prevent it from being fabricated.

Therefore, before proceeding to verify payment made on account of salaries and wages, the auditor should examine the internal control procedure as regards the following :

(a) Appointment, promotion, transfer and discharge of employees.

(b) Recording attendance of workers engaged on the time basis, as well as particulars of jobs performed by piece workers.

(c) Arrangement for the preparation of wages and salaries bills and their analysis.

(d) Sanctioning the disbursement of wages and salaries.

(e) Arrangement for disbursement of wages and salaries for workers and employees not present on the pay day.

(f) Custody of the wages records.

He should also verify that the system of internal control provides for the following matters :

(a) Mechanical recording of attendance of workmen by time recording clocks installed at the factory gate, as well as in each department and the reconciliation of the total labour force with the total of workmen in different departments ; also the recording of attendance of the staff departmentally in separate registers.

(b) Preparation of wages and salary bills by members of the staff, who are not connected with maintaining a record of engagement of workers, recording of their attendance or fixation of their wages.

(c) Rotation of duties of different clerks employed for preparation of wages and salaries bills so that calculations, additions and extensions are not carried out by the same clerk every month. Also, signing of the statement by persons who have prepared them and indication by each person so employed of the nature of work carried out by him.

(d) Verification of salaries and wages bills in case of newly appointed persons by reference to orders for appointment, promotions or transfer made during each month and of those payable to old employees by reference to old records and on reference to the record of attendance.

(e) Verification of the amount of total wages paid with the amount adjusted in the costing record.

(f) Checking and authorising the overtime and piece work payment by officers who are not associated with the Wages Department.

(g) Withdrawal by a single cheque from the bank of the exact amount of wages and salaries payable as are entered in the wages and salaries bill, depositing in the bank the undisbursed amounts.

(h) Recording of unclaimed wages and salaries immediately in the Unpaid Wages and Salaries Register, and their subsequent payment on the employee's claim to them.

(i) Payment of advances in lieu of wages and salaries to persons who go on leave on short notice before the end of the month through the Petty Cash.

(j) Disbursement of wages in the presence of an official who is in a position to identify the worker and ensure that wages are not being paid to persons other than the workmen except under a proper authority.

Provided that the system of internal control has built-in safeguards against payments being made in excess, the auditor should check the wages and salaries bills for one month as follows :

(a) Check the bill in detail by reference to the record of attendance, schedule of rates, sanctioned by the management for different classes of workers and employees and the sanction for their payment.

(b) Check the computation of wages and salaries payable to different workers and employees by taking into account the deduction and other factors on a consideration of the following :

  (i) Absence ;

  (ii) Leave with pay ;

  (iii) Loans and advances ;

  (iv) Increments ;

  (v) Fines and penalties ;

  (vi) Deduction on account of Provident Fund and Income-tax ;

  (vii) Deduction on account of contribution towards Employees' State Insurance, etc.

(c) Verify the addition, extension and classifications of wages and salaries for distributing them among different accounts.

(d) Confirm that all payments to workers and other employees have been acknowledged and amounts which have remained undisbursed have been deposited back in the bank and credited to the Unpaid Wages and Salaries Account. Also, check disbursement of unpaid wages and salaries made during the month.

(e) See that wage sheets are signed by the persons who have prepared wage sheets and disbursed wages ; also that they have indicated precisely the nature of work carried out by them.

(f) Test the correctness of the amount paid by reference to the Annual Return of Salaries, etc., submitted to the Income-tax Authorities and that of wages with Employee's State Insurance Cards.

(g) Trace recoveries out of loans and advances, outstanding against employees into the Employees Loans and Advances Register.

(h) See that names of the same persons do not always appear on the list of unpaid wages if their wages are not, from time to time, adjusted against their loans and advances to prevent their absence being noticed at the time wages are paid. It might provide a clue that the workmen are dummies.

If the aforementioned checking does not disclose significant mistakes, either in the preparation of wages and salaries bill or in their disbursements, the auditor could verify the wages and salary bills for the rest of the period by the application of the following checks :

(a) Test checking the amount of wages and salaries, shown as payable in the bill, to a selected list of employees by reference to their attendance record as well as Employees Insurance Cards ; also verifying the rate of wages and salaries at which the amount due have been computed on an inspection of the authority under which they were engaged.

(b) Verifying the disbursement of all wages and salaries by reference to receipts furnished by employees or their authorised representatives on the salaries and wages bill.

(c) Verifying the amounts withdrawn each month from the bank for payment of the salaries and wages bill.

(d) Reconciling the amounts deposited in the bank each month with that undisbursed shown in the relevant bill.

(e) Vouching all payment made on account of wages and salaries that had remained unclaimed on the pay day.

5.2.15 Petty Cash

Note : *Students should study carefully from the Spicer and Pegler's book the system of internal check that should exist in respect of payments made from petty cash.*

Payments from petty cash should be verified as follows :

(i) Trace the amounts advanced to the petty cashier for meeting petty office expenses from the Cash Book in the Petty Cash Book.

(ii) Vouch payments with docket vouchers which must be supported, wherever possible, by external evidence e.g., payee's receipted bill or invoices, cash memo, etc.

(iii) Trace payments made for the purchase of postage stamps recorded in the Postage Book. The totals of the Postage Book should be test checked. The amounts of postage stamps in hand, at the end of the year, should be credited to Postage Account by debiting the amounts to Postage in Hand Account. It should be seen that the amount paid for postage stamps is not unduly large and the Postage Book is normally checked by the petty cashier from time to time before the amount of imprest is reimbursed. Confirm that the postage expenses for the year is reasonable as compared with that in the postage expenses from month to month.

(iv) See where a columnar Petty Cash Book is maintained, that the extension have been carried forward into appropriate amount columns.

(v) Check the column totals and cross totals.

(vi) Trace posting of the various columns in which payments are classified to the respective ledger accounts.

(vii) Verify the cash balance in hand.

(viii) Auditor should also verify whether the amount of petty cash imprest is fixed. Is this amount reasonable considering the total amount of petty cash payments made during a month or so?

5.2.16 Advertisement Expenses

The advertisement expenses will be vouched in the following manner :

(a) Ascertain the nature of advertisement expenses to ensure that the same have been charged properly.

(b) Obtain the complete list of advertisement, mediawise, i.e., newspapers, slides, hoardings, magazines, television, radio, etc. showing the dates, exact location, timings, etc., along with the amounts paid in respect of each category.

(c) See that advertisement expenses relate to the client's business.

(d) Ascertain whether there is a regular contract with an advertising agency. See that regular statements are obtained from the agency showing the advertising media and amounts debited to the client. Discounts, if any, should be properly adjusted and disclosed in the bills.

(e) Check the receipts for amounts paid for the advertising expenses incurred.

(f) See that outstanding advertising expenses have been properly disclosed on the liabilities side of the balance sheet.

5.2.17 Payment of Dividends

(a) Examine special provisions, if any, in the Memorandum and Articles of Association regarding payment of dividends.

(b) See that in declaring dividends, provisions of the Companies (Transfer of Profits to Reserves) Rules, 1975 have been complied with.

(c) Examine the Board's minutes regarding rate of dividends.

(d) Examine the company's procedure for payment of dividends including unclaimed dividends and ensure that they are not paid without adequate safeguards as to identification of the payee, checking of the payee's claims etc. In this connection, internal control of the company should be examined.

(e) Verify the shareholders' register and ensure that the names of all shareholders who are entitled to receive dividends have been included.

(f) Check the computation of dividends with reference to rate of dividends and number of shares held.

(g) See counterfoils of cheques for amounts paid to shareholders.

(h) Examine, whether all the conditions for payment and source of dividend as specified on section 205, 205A and 205B, have been complied with.

It may be noted that the Institute has issued a Guidance Note on Audit of Payment of Dividends.

5.2.18 Retirement Gratuity to Employees

(a) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.

(b) Ensure that the basis of computing gratuity is valid.

(c) Verify computation of liability of gratuity on the aggregate basis.

(d) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.

(e) See that the annual premium has been charged to Profit and Loss Account in case the concern has taken a policy from LIC.

(f) Ensure that the accounting treatment is in accordance with AS-15 (Revised), "Retirement Benefits".

5.3 CASH RECEIPTS

The function of audit in respect of cash receipts being much the same as that in the case of cash payments, the procedure stated at the beginning of this Chapter should be applied for their verification. But the internal check in respect of cash receipts should be closer and stricter, primarily because these have to be verified generally only by reference to the internal evidence which, if it is not in existence or is manipulated, would not be of any assistance for the detection of incomes that either have not been credited or have been credited only partially. For example, if in respect of sale proceeds of goods or an item of miscellaneous income no bill or voucher has been prepared, audit would not disclose that the amount has been misappropriated. Similarly, if the amount on the copy of a cash memo has been cleverly altered from Rs. 50 to Rs. 5 and the latter amount only has been entered in the Cash Book, unless the alteration is detected and the fact that it has been altered is established, it would not be possible for the auditor to know that part of the cash sales has been misappropriated.

On this account, it is essential that the auditor before starting the audit of cash receipts, should examine the internal check in operation and bring to the attention of the management any weakness therein, as well as to the possible consequence that might follow if it is not removed. If he fails to do so, he may be held responsible at some later date for not having detected a defalcation or misappropriation in cash, the cause of which was the absence/inadequacy of the internal check.

Cash receipts are usually checked with counterfoils of the receipts issued. But the issue of receipts with counterfoils in respect of amounts collected by itself would not ensure that all the amounts collected have been fully accounted for or have been correctly adjusted. For instance, a receipt might be issued for a larger amount than entered on its counterfoils. Again, only one receipt might have been issued for two or more amounts collected from a party while the counterfoils may show that separate receipts have been issued in respect of each amount collected and the one or more receipts forms, thus

saved, may have been used for issuing a receipt of another amount collected which have been misappropriated. Therefore, before accepting counterfoils or receipts as evidence or the correctness of the amount collected, the auditor should satisfy himself that there exists an efficient system of internal check which would prevent any receipt from being misappropriated. For the purpose, the auditor should make the following enquiries :

(i) Who opens letter, what record is kept, and whether all cheques and postal orders are immediately endorsed to bankers and crossed 'Account Payee Only' ?

(ii) Whose duty is to enter cash, cheques and other forms of remittance in the Pay-in-Slip and who deposited it in the bank ?

(iii) Are receipts banked daily ?

(iv) Who prepares receipts and who countersigns the same before these are issued to the parties from whom the amounts have been received ?

(v) Whether printed receipts with counterfoils, numbered serially by a machine, are used and who maintains the stock of unused receipts ?

(vi) Are the receipt books kept in safe custody and are they issued only when the current receipt book has been used up ?

(vii) What internal check is being exercised over the collection of cash sales and miscellaneous income ?

(viii) Are travelling salesmen allowed to collect any advance against orders booked and what control exists over such collections ?

(ix) How often are the bank statements checked and compared with the Cash Book ?

(x) Who controls the preparation and despatch of monthly statements of account to customers ?

(xi) Are ledgers posted by the cashier or some other person ?

There are certain firms which insist upon a receipt furnished to them on their own forms. In such a case, this fact should be noted on the counterfoil of the receipt which has been issued and the unused receipt form cancelled, as an additional precaution, balances in such customer's should be get confirmed periodically.

While vouching cash receipts, it should be seen that the date of each receipt as it is entered in the cash memo or the counterfoil of the receipt issued in respect thereof corresponds with the date on which it is entered in the Cash Book. If there is a time lag between them, it is possible that the person who had collected the amount had failed to deposit it with the cashier immediately thereafter. When such a discrepancy is observed, the cause thereof should be ascertained.

5.3.1 Cash Sales

Primarily, the system of internal check should be examined with the objective of finding out loopholes therein, if any, whereby cash sales could be misappropriated. Further, the practice followed in the manner cash memos are issued should be ascertained. Because in case, cash memos are issued not only for cash sales but also for credit sales, the amount whereof if collected long after, there would be no guarantee that all the amount of cash sales has been collected before the close of year or that some of the amounts collected have not been misappropriated.

Cash sales usually are verified with carbon copies of cash memos. If sales are quite voluminous then a Cash Sales Summary Book is maintained and the cash memos are traced into it; the totals of the Summary Book are verified and the daily totals of the Summary book traced into the Cash Book. One of the matters, to which attention of the auditor should be paid in the process is that the dates on the cash memos should tally with those on which cash collected in respect thereof has been entered in the Cash Book.

To verify that price of goods sold has been calculated correctly, the computation of the sales should be ascertained. If a cash memo has been cancelled, its original copy should be inspected, for it could be that the amount thereof has been misappropriated.

5.3.2 Receipts from Customers

Receipt of cash from the customers against price of good sold are checked with the counterfoils of receipt issued to them. At the same time, it is also verified that there is a system of internal check in operation which acts as a safeguard against amounts collected being misappropriated.

One of the common devices for misappropriating cash collections from customers is the one known as *Teeming* and *Lading.* Such a fraud, usually, remains undetected for long since the cashier is able to make good the amounts misappropriated before the cash balance is checked. At times, the cashier who has committed such a fraud may cover up the amounts misappropriated, by raising a fictitious debit in an expense account.

When such a fraud is suspected, the first step in its investigation should be making comparison of the entries of amounts deposited in the bank account with those on counterfoils of the Pay-in-Slip Book. If the composition of the deposits is different from that shown on the counterfoils of the Pay-in-Slip Book, it would be a *prima facie* evidence of the fact that the amounts collected were not deposited as soon as these were received. Another evidence of the existence of such a fraud can be the fact that debits in customers' accounts, which ought to have collected in whole, are cleared in small instalments.

If such an evidence exists, the matter should be investigated further. This can be done by all the customers being requested to send statements of account from their books, for the period during which the fraud is suspected to have been in progress. On comparing items in each statement, with the entries in the customer's accounts, it would be possible to locate amounts which were not deposited on the day these were collected, but subsequently.

5.3.3 Income from Investments

If the investments are many, the client generally would have an Investment Register. In such a case, the dividend income is first vouched by reference to the counterfoils of Dividend Warrants and the interest on securities by reference to the tax-deduction certificates, issued by the Reserve Bank. Afterwards the amounts collected are traced into the Investment Register; it is scanned to find out whether interest or dividend, relating to any investment, has remained unrealised. If so, the reasons, thereof are ascertained. In order that the gross amount of interest are disclosed in the Profit and Loss Account, the tax deducted out of interest is debited to the Income-tax Account and credited to Interest Account. The auditor should verify that this has been done.

5.3.4 Rental Receipts

Before proceeding to vouch rental receipts, copies of bills issued to tenants should be test checked by reference to copies of tenancy agreements and bills of charges paid by the landlord on behalf of the tenants, *i.e.,* house tax, water tax, electricity consumed, etc. The entries in the Rental Register in respect of rents accrued afterwards should be verified by reference to copies of rental bills. The amounts collected from tenants on account of rent should be checked by reference to receipts issued to them. These afterwards should be traced into the Rental Register.

At the end, the register should be scrutinized to find amount or rents which have not been recovered and are considered bad or irrecoverable, for deciding whether these should be written off or as provision against the same should be made.

An overall check over rental receipts is also necessary. For this purpose, particulars of total accommodation available for being let out, in different buildings, belonging to the client, should be ascertained. It should be verified that every available accommodation has been let out and rental income has been duly accounted for. If it is reported that one or more tenements have remained vacant a certificate in respect thereof should be obtained from the client.

5.3.5 Bankruptcy Dividends

When a debtor has been sued for bankruptcy it is necessary to prove that the debt is due from him to the Official Receiver or Assignee before any amount can be recovered from his estate. The amounts of claim admitted are received subsequently, usually in parts, which are referred to, somewhat euphemistically, as dividends.

For the verification of these part amounts, it is necessary to refer to the correspondence with the Official Receiver or Assignee to find particulars of part amounts already collected and the balance outstanding at the beginning of the year. The advice, if any, received from the same authority along with the payment should be referred to.

5.3.6 Sale of Investments

Only the person who is authorised to purchase an investment can sell an investment. Thus, in the case of a company, an investment can be sold only by the Board of Directors and in the case of a trust by the trustees acting together. The normal method of selling investment is through Stock Broker, either directly or through a bank; the sale proceeds of investments are vouched by reference to Brokers' Sold Note. On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement. When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment. AS-13 requires disclosures of amounts included in profit and loss statement for:

- interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid;
- profits and losses on disposal of current investments and changes in the carrying amounts of such investments; and
- profits and losses on disposal of long term investments and changes in the carrying amount of such investments.

5.3.7 Loans

Primarily, the authority under which a loan has been raised should be verified. An unauthorised loan cannot be treated as a liability of the concern. The copy of the loan

agreement should be referred to find out the rate of interest, the terms of repayment and the conditions as to security agreed to by the client. If any guarantee has been provided for the repayment of the loan the particulars thereof should be ascertained for the purpose of disclosure in the balance sheet.

5.3.8 Bills Receivable

The amount collected in respect of bills receivable are verified by reference to Bills Receivable Book. When bills are purchased, a provision for the amount of the discount, not earned till the close of the year is made in the accounts, in the case of bank. If the bills have been discounted, the contingent liability in respect of the discounted bill is disclosed in the balance sheet, also bills which have since been paid off are shown separately. Enquiries should be made from the client as regards the position of a bill or bill receivable dishonoured and if it is suspected that the amount due on a bill may not be recovered, a provision thereof should be made.

5.3.9 Sale of Assets

In this case also, as in the case of sale of investments, the authority for sale is most important. It is, therefore, a matter which should receive the attention of the auditor. Another important aspect which requires consideration is the basis of sale, whether by auction or by negotiation, for determining that the asset was sold at the maximum price that could be contained for it and that the sale proceeds of the asset have been fully accounted for. It should further be confirmed that sale proceeds have been credited to an appropriate head of account and the amount of profit arising out of it has been segregated between revenue profits and capital profits, if any, accordingly appropriate accounts are credited, where there is a loss, the same should be written off.

5.3.10 Royalties received

The auditor should see the relevant contract and examine the important provisions relating to the conditions of payment of royalty. In particular, the rate of royalty, mode of calculation and the due dates should be noted. The periodical statements received from the publisher and the calculation of the royalty should be checked. If there is any deduction on account of recoupment of royalty for the past period, the records for earlier royalty receipts should be seen to ensure that the amount of deduction is as per the contract. Royalties due but not yet received should have been properly accounted for.

5.3.11 Interest and Dividends received

The auditor should examine the separate ledger accounts kept for each investment or loan given. The dates on which dividends or interest payments generally fall due should also be noted. The counterfoil of dividend warrants should be seen. These should be tallied with the records of investment. Where investments are sold ex-dividend, it should be seen that the dividends are subsequently received. Similarly when a purchase is on *cum* dividend basis, the receipt of dividend should be checked. In case of interest on deposit with banks, verification should be done by reference to the bank's statement and the agreed rate of interest. The receipts of dividends and interest should be addressed to the bank statement for encashment. It should be ensured that the interest and dividend received are credited to the respective account in full *i.e.,* before deduction of tax at source and the tax deducted at source should be debited to an appropriate account. It should be further seen that the certificate for tax deducted at source exists in each case.

5.3.12 Insurance Claims

Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims, the auditor should examine a copy of the insurance claim lodged with the insurance company. Correspondence with the insurance company and the insurance agent should also be seen. Counterfoils of the receipts issued to the insurance company should also be seen. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. The copy of certificate/report containing full particulars of the amount of loss should also be verified. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against an asset, the profit and loss account is debited with the shortfall of the claim admitted against the book value. If the claim was lodged in the previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

5.3.13 Sale Proceeds of Junk Materials

(a) Review the internal control on junk materials, as regards its generations, storage and disposal and see whether it was properly followed at every stage.

(b) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of junk materials.

(c) Review the production and cost records for the determination of the extent of junk materials that may arise in a given period.

(d) Compare the income from the sale of junk materials with the corresponding figures of the preceding three years.

(e) Check the rates at which different types of junk materials have been sold and compare the same with the rates that prevailed in the preceding year.

(f) See that all junk materials sold have been billed and check the calculations on the invoices.

(g) Ensure that there exists a proper procedure to identify the junk material and good quality material is not mixed up with it.

(h) Make an overall assessment of the value of the realisation from the sale of junk materials as to its reasonableness.

5.3.14 Recovery of Bad Debts written off

Bad debts written off are verified with reference to relevant correspondence and proper authorisation.

(a) Ascertain the total amount lying as bad debts.

(b) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(c) Examine notification from the Court or from bankruptcy trustee. Letters from collecting agencies or from debtors should also be seen.

(d) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(e) Vouch acknowledgement receipts issued to debtors or trustees.

5.3.15 Refund of General Insurance Premium paid

The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds :

(a) Ascertain the reasons for refund of insurance premium.

(b) Examine insurance policy or cover note to find out the amount of premium.

(c) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be an evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.

(d) Scrutinise correspondence between the insurance company and the client.

(e) Check entries in the bank book or the bank statement. If necessary counterfoil of the pay-in-slips can also be verified.

5.3.16 Discounted Bills Receivable Dishonoured

(a) Obtain the schedule of discounted bills receivable dishonoured.

(b) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.

(c) Verify the bills receivable returned by the bank alongwith bank's advice.

(d) See that the dishonoured bills have been noted and protested by following the proper procedure and the account of the drawee or the debtor is also debited.

(e) Check that bank commission, if any, charged by the bank has been recovered from the party.

5.4 VERIFICATION OF BANK BALANCE AND CASH-IN-HAND

5.4.1 Verification of bank balance

Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book. If the bank account is overdrawn, the auditor should obtain from the bank particulars of assets on which a charge has been created to secure the overdraft. The auditor should examine the bank reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statement prepared as on the last day of the year. He may also examine the reconciliation statements as at other dates during the year. It should be examined whether (i) cheques issued by the entity but not presented for payment, and (ii) cheques deposited for collection by the entity but not credited in the bank account, have been duly debited/credited in the subsequent period. For this purpose, the bank statements of the relevant period should be examined. If the cheques issued before the end of the year have not been presented within a reasonable time, it is possible that the entity might have prepared the cheques before the end of the year but not delivered them to the parties concerned. In such a

case, the auditor should examine that the entity has reversed the relevant entries. Where the auditor finds that post-dated cheques are issued by the entity, he should verify that any cheques pertaining to the subsequent period have not been accounted for as payments during the period under audit. The auditor should pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment/ write-off. The auditor should be alert to the possibility that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

Where a large number of cheques has been issued/deposited in the last few days of the year, and a sizeable proportion of such cheques has subsequently remained unpaid/uncleared, this may indicate an intention of understanding creditors/debtors of understating/overstating bank balances. In such a case, it may be appropriate for the auditor to obtain confirmations from the parties concerned, especially in respect of cheques involving large amounts. The auditor should also examine whether a reversal of the relevant entries would be appropriate under the circumstances. In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements. In respect of fixed deposits or any type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined. Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases. The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year. Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases. Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances. The following areas may also be considered by the auditor:

(i) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(ii) In respect of fixed deposits or any other type of deposits with banks, the relevant receipts/certificates, duly supported by bank advices, should be examined.

(iii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(iv) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(v) Where material amounts are held in bank accounts which are blocked, e.g., in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(vi) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

5.4.2 Verification of Cash-in-hand

The auditor should carry out physical verification of cash at the date of the balance sheet. However, if this is not feasible, physical verification may be carried out, on a surprise basis, at any time shortly before or after the date of the balance sheet. In the latter case, the auditor should examine whether the cash balance shown in the financial statements reconciles with the results of the physical verification after taking into account the cash receipts and cash payments between the date of the physical verification and the date of the balance sheet. Besides physical verification at or around the date of the balance sheet, the auditor should also carry out surprise verification of cash during the year.

All cash balances in the same location should be verified simultaneously. Where petty cash is maintained by one or more officials, the auditor should advise the entity to require the officials concerned to deposit the entire petty cash on hand on the last day with the cashier. The auditor should enquire whether the cashier also handles cash of sister concerns, staff societies, etc. In such a case, cash pertaining to them should also be

verified at the same time so as to avoid chances of cash balances of one entity being presented as those of another.

If IOUs ('I owe you') or other similar documents are found during physical verification, the auditor should obtain explanations from a senior official of the entity as to the reasons for such IOUs/other similar documents remaining pending. It should also be ensured that such IOUs/other similar documents are not shown as cash-on-hand.

The quantum of torn or mutilated currency notes should be examined in the context of the size and nature of business of the entity. The auditor should also examine whether such currency notes are exchanged within a reasonable time.

If, during the course of the audit, it comes to the attention of the auditor that the entity is consistently maintaining an unduly large balance of cash- on-hand, he should carry out surprise verification of cash more frequently to ascertain whether the actual cash-on-hand agrees with the balances as shown by the books. If the cash-on-hand is not in agreement with the balance as shown in the books, he should seek explanations from a senior official of the entity. In case any material difference is not satisfactorily explained, the auditor should state this fact appropriately in his audit report. In any case, he should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the entity. The entity may also be advised to deposit the whole or the major part of the cash balance in the bank at reasonable intervals.

Where postdated cheques are on hand on the balance sheet date, the auditor should verify that they have not been accounted for as collections during the period under audit.

5.5 AUDIT OF TRADING TRANSACTIONS

5.5.1 General Considerations

In addition to matters which are listed in the audit of cash transactions, certain other principal matters that should be taken into account while vouching trading transactions are :

(i) *Correctness of book-keeping record* : The auditor should also take steps to verify that the amount of profit has not been overstated, *e.g.*, by the inflation of sales or closing stock, by the understatement of purchase and expenses or by omission to credit customers accounts with the value of goods returned by them, etc. The figure of profit can also be inflated by the failure to provide for losses and depreciation or reduction in their value for instance, by not making an adequate provision for bad debts, for discounts payable on

the recovery of book debt, for any fall that has taken place in the value of investments or stock. In such a case, the final accounts would not disclose a 'true and fair' stage of affairs of the business.

Likewise, it should be verified that profits have not been understated. In the case of companies, there is a specific restraint in this regard contained in Part III of Schedule VI to the Companies Act, 1956. It prescribes that a provision, which is in excess of the amount considered reasonable by directors must be treated as a reserve. In consequence, any provision of bad debts, depreciation, expenses, or liabilities which is in excess of the sum considered reasonable, must be treated as a reserve.

(ii) *Observance of accounting principles* : Students are already aware of the implications of all these requirements; nevertheless, there is a necessity for a fresh look into these with a view to knowing how trading results can be upset if any of these are not properly followed. If the distinction between capital and revenue is not kept in mind in recording transactions, the profit or loss would be wrongly stated; as a consequence, there would not be a true statement of assets in the balance sheet. For example, if an amount representing installation cost of a machine, has been wrongly treated as a revenue expense charged off in the year's account, the profit for the year would be understated to the extent of the charge and the value of machine also would be understated. If the benefit of an expense incurred in a given period is not fully realised within that period, it would be proper to carry forward the appropriate proportion of the expense in the books of account without charging that amount wholly to revenue. For example, if annual insurance premium is paid at the end of third quarter of the financial year of the concern, it would be appropriate that only 1/4th of the total premium should be charged in that year's account and the rest carried forward to be charged off in the next year when the benefit from the premium would be exhausted.

Similarly, if commission has been earned by salesmen for effecting sale within the year, the same should be provided in the accounts irrespective of whether a bill for commission has been received or not within the year. It is a common knowledge that the value of fixed assets depreciates due to efflux of time, use and obsolescence. The diminution of the value represents an item of cost to the concern for earning revenue during a given period. Unless this cost is charged to the accounts, the profit or loss would not be correctly ascertained and the values of fixed assets would be shown at higher amounts. Likewise, current assets, if they are stated at more than the realisable value, the year's profit or loss would not be fairly stated. For example, if the figure of sundry debtors, includes some accounts which are not realisable, this is a loss to the concern and it should be provided as soon as it is known. Also, fictitious assets like a worthless patent,

trade mark or developmental expense should be written off at the earliest so that the net value of the business can be really known and the infructuous expenses are absorbed by the revenue earned by the business and the true surplus is reflected in the books as profits.

Stock-in-trade stands on a slightly different footing in as much as no running account in the financial record is generally maintained for stock. At the year end, the physical quantities of the stocks in hand are noted and values are applied to them to arrive at the value of the closing stock. Often the stock records also provide the basis for ascertaining quantities in hand on the closing day. This being an asset, representing a part of the stock purchased or acquired in the year or earlier needs to be brought into books of account for a fair ascertainment of the profit or loss. Closing stock account is debited and trading account is credited for giving effect to the adjustment required in the revenue account and for bringing the stock as an item in the accounts. It is therefore obvious that any mistake, error or fraud in the aforesaid process of bringing stock into financial books will have considerable impact on the year's trading results and assets position. To obtain a true and fair view of the accounts, the correctness, appropriateness and consistency of the verification and valuation bases and methods are of great significance.

Students, no doubt, are aware that except for any physical losses that the goods may suffer, during the manufacturing process or due to some extra-ordinary factors, *e.g.,* fire or pilferage, there should be no difference in the total of the quantities of goods entered on either side of the Trading Account *i.e.,* the quantities of opening stock and the quantities purchased or produced should be equal to the quantities of goods sold and those held in stock at the close of the year. It is the duty of the auditor to verify that there has not been any loss or leakage of goods in the process of trading. He should, therefore, reconcile the closing stock with the opening stock on taking into account the quantities of goods purchased and sold. If there is a discrepancy, he must locate the cause thereof. Some of the factors which give rise to discrepancy in the stock are stated below :

(a) Inclusion in the closing stock of goods that should have been returned to suppliers and non-inclusion of goods returned by customers.

(b) Inclusion in the closing stock of goods received for sale on approval or on a consignment basis and, conversely, non-inclusion in the closing stock of goods sent out for sale on approval or on consignment basis.

(c) Failure to adjust the quantities of stocks lost by fire or given away as samples.

(d) Failure to adjust any sales, the proceeds whereof have been misappropriated, or purchases, the bills in respect of which had not been received from the suppliers.

(e) Failure to include goods purchased that were in transit at the close of the year and to exclude goods which had been sold but not delivered.

(f) Non-adjustment of the losses in weight of material in the process.

In this connection, it is necessary to mention that since the closing stock of one period becomes the opening stock of the next, it is essential that the stock should be valued consistently from year to year; otherwise a part of profit or loss of one period will be transferred to the next. On this consideration, it is provided under clause (3)(*xv*) of Part II of Schedule VI to the Companies Act, 1956 that the effect of any change in the basis of accounting, of any item shown in the Profit and Loss Account, should be disclosed. In such a case both the particulars of the change in the basis of valuation of stock, as compared to that in the previous year and the amount by which the profit or loss has increased or has reduced as a consequence should be disclosed. Students may also refer to AS-2 on Valuation of Inventories. As a matter of general principle, AS-1 "Disclosure of Accounting Policies" states that consistency is one of the fundamental accounting assumptions. The change in accounting policy, if any, requires appropriate disclosure.

(iii) *Checking of stock and record* : The stock accounts are an integral part of the financial accounts. Therefore, any inaccuracy in one affects the other. It is necessary, therefore, that while checking entries of purchases and sales in the financial books, corresponding entries in the stock accounts also should be checked. In a large concern, this is a stupendous task, on account of the large volume and variety of stocks purchased and sold. In the circumstances, it is practicable for the auditor to only test check the stock entries. In case no mistakes are found, he can accept the correctness of entries not checked provided there exists an efficient system of internal check. He must, however, reconcile the quantities of goods purchased and sold with the balance at the close of the year.

5.5.2 Internal Control in Respect of Trading Transactions

Trading is a chain of business process of buying, taking delivery of goods bought, making proper arrangements for their storage and issuing them on sale, etc. The function of audit, in this background, is to ensure that there is no leakage of goods or cash; also that the goods that are purchased have been received and are of the type dealt in by the firm, the prices are normal and the goods have been duly accounted for. It is, therefore, the duty of the auditors to see that the trading establishment, the accounts of which he is called upon to audit, has devised a system of internal control as a safeguard against the losses that may arise out of the foregoings. This he performs by reviewing the system. The principal features of such a system are briefly outlined below.

Buying : Buying should be a function independent of receiving, storage and despatching. There should exist a proper a procedure for buying, as regards who shall authorise a purchase, on what basis purchases are to be made, from whom to buy and in what quantity, etc.

The goods, if possible, should be purchased by a separate Purchase Department. The department should be constantly receiving information as regards prices prevailing in different supply centres and have knowledge as regards the allowance, if any, that should be made, the price of every commodity prevailing in one centre as compared to that in another on consideration of freight, quality and other allied factors. The buying department should maintain an up-to-date list of suppliers and manufacturers of various commodities, dealt in by the concern with a note on their usual terms of trade and past performance. In respect of commodities or brands which are not so well known in the market, it is desirable that the view of the Sales Department should be obtained before an order is placed for purchase of such commodities or brands. It would also be prudent to avoid bulk purchase of such commodities/brands until consumer acceptance is evident. For purchasing such commodities, there should be a system of inviting quotations from a number of suppliers or manufacturers.

When the purchase department decides to place an order for the purchase of commodities or goods, a purchase order, preferably standardised, should be prepared in quadruplicate; it should specify the name of the supplier, the goods ordered with specifications as to quantity, quality, source, etc. the date of supply and the price agreed to. It should also specify the other terms about delivery, freight, insurance, etc. One copy of the Purchase Order should be forwarded to the Accounts Department and another to the Receiving Department. If the order has been placed on the basis of a sample, the sample should also be forwarded to the Receiving Department. The purchase order forms should be pre-numbered and the internal reference number should be given to identify the purchase indent sent by the Stock Department. Any purchase which is initiated on indent of any section other than the Stock section, should be authorised by the concerned departmental head and manager.

Receipt of goods : The responsibility for the receipt of all incoming goods should be centralised in a separate department. The responsibilities of the Receiving Department should be the following :

(a) Verifying all receipts as to the quality and quantity by comparison with the copy of the purchase order issued by the Purchase Department and the forwarding challan of the supplier. The goods should be checked for damage, leakage, etc.

(b) Entering the goods immediately on receipt in the Goods Inward or Goods Received Book.

(c) Drawing up in quadruplicate a Goods Received Note for each consignment.

(d) Transmitting the material in the Stock Department along with a copy of the G.R. Note as aforementioned and obtaining a receipt for the goods for constituting the record of the department.

Before accepting the goods, the Stock Department sends a note to the Inspection Department for checking the quality and specification. Only on getting a clearance from this department, the goods are accepted. A copy of the Inspection Note is usually attached to the Goods Received Note.

The original copy of G.R. Note should be retained in the Receiving Department as a permanent record of receipt, preferably bound up in the numerical sequence of receipts. One copy of the note should be handed over to the supplier for being enclosed with the invoice he would be sending for the supply made. The second copy should be forwarded to the Stock Department along with the goods and the third copy to the Purchase Section to enable it to follow up any non-supply or short supply made by the supplier. It would be a good internal check if the Accounts Section, before passing any invoice for supplies made, compares the suppliers copy of the note as enclosed with the invoice with that in the Stock Department because it is from that copy that entries in the stock records have been made.

Storage : (*a*) No sooner the quantity of any article in the godown reaches the ordering level specified on the Bin Stock Card then the stock-keeper should prepare an indent, stating the particulars of goods to be purchased, the quantity required, the date and quantity of goods which was last ordered, the name of the party from whom the goods were obtained and other particulars considered relevant. The indent should be forwarded to the Purchase Department.

(b) The goods should be stored in a manner to ensure that :

(i) they are easily accessible and at no time are obscured from view;

(ii) they do not suffer any deterioration during storage;

(iii) they occupy the minimum amount of space;

(iv) necessary segregation has been made in the matter of storage of fast moving and relatively slow moving items and easier accessibility has been arranged for the former type.

Also, it should be ensured that the goods are adequately insured against fire, theft, etc. and that conditions of the insurance policy are complied with.

Issues : (*a*) All deliveries from the sales-godown under all circumstances, should be made on delivery notes signed and authorised by the Sales Department. Where credit is to be allowed to the customer, the Sales Department should obtain the prior approval of the Accounts Departments.

(*b*) The requisition slip should be prepared in quadruplicate. The original copy should be retained by the Sales Department as a permanent record of the sale made. Two copies should be forwarded to the Stock Department. This department in turn should retain one copy in its record as evidence of goods having been issued, after it has been acknowledged by the Despatch Department and surrender the other to the Despatch Section along with the goods. The fourth copy should go to the Accounts Department. It will the basis on which the Accounts Department shall prepare the bill for the customer on receiving a copy of the despatch note from the Despatch Department.

(*c*) The Stock Department, on releasing the goods, should make an entry on the Bin/Stock Card.

(*d*) The goods on release from the sale godown should be sent to the Despatch Department, alongwith both the copies of the requisition slip; one should be obtained back duly signed in acknowledgement of the fact that the goods have been received for despatch. It should be placed on the file in the Stock Department.

(*e*) After the goods have been despatched, the Despatch Department should prepare a despatch note in quadruplicate. One copy of the note should be forwarded to the Accounts Department and another to the Sales Department for reporting to it that the goods sold have been despatched; from the third an entry would be made in the Goods Outward Book; and the fourth is to accompany the goods.

(*f*) The requisition slip forms should be pre-numbered and the control over them should be kept by the Sales Department. All forms that are spoiled should be kept in the file.

(Students may note that the person who has got finished stock in his custody is described as the stock-keeper and the department dealing with the goods as the stock department. Likewise, the person who has in his custody the stores of raw materials, manufacturing stores, etc. is described as the store-keeper and the department is referred to as the stores department.)

5.5.3 Internal Control in Respect of Services

The provision of service also constitutes trading, *e.g.,* those rendered by a contractor, estate agent, repairer of motorcars, etc. In those cases, the internal check should provide for the regulation of the charges for the services rendered, either according to an agreement entered into with the parties, to whom the services have been provided, or on the basis of costs incurred in providing the service, a record in respect whereof is maintained. For instance, the charge for a construction job should be regulated according to the agreement entered into with the party; and in case any subsequent modification has been made therein, involving additional work, the charge should be modified accordingly. A motor repairing workshop or an estate agency office should regulate its charges according to the time taken and the expenses incurred in rendering the services. Similarly, a solicitor should charge for the specific item of work handled for the client. A record of work done should be maintained in the time sheets or in diaries which should be posted regularly, to obviate the possibility of the client being undercharged.

It is the duty of the auditor to verify that an appropriate internal check exists in respect of different types of transactions entered into by the client to ensure that all the income receivable has been properly accounted for and adequate precautions have been taken to control expenses.

5.6 AUDIT OF PURCHASES

The purchases on credit should be verified by reference to the suppliers invoices to which generally copies of delivery notes, disclosing the dates and particulars of goods received and acknowledged by the Receiving Department, are also attached. While vouching entries for purchases with the invoices, the following points should be specially observed :

(a) that the date of invoice falls within the accounting period;

(b) that the invoice is made out in the name of the client;

(c) that the supplier's account has been credited with the full amount of the invoice and that the deduction in the amount of the invoice, if any, has been made on a proper basis;

(d) that the goods purchased are those that are regularly dealt in by the concern or required for the process of manufacture carried on by it and that the price payable has been correctly arrived at;

(e) that the cost of purchases has been debited to an appropriate nominal account or accounts;

(f) that the invoice is signed by the accountant to show that he has verified it as well as the store-keeper to indicate that the delivery of goods have been taken by him. If the invoice relates to the purchase of a technical store or a chemical, the price whereof is dependent on its quality, a copy of the report of a technical person showing that the article purchased is of the specification for which the order has been placed; and

(g) that the manager or some other official, competent to sanction payment, has authorised its payment.

Classification of purchases : For controlling expenditure on purchases it is essential that these should be classified under the following heads:

(1) Purchases of raw material, for each material separately.

(2) Purchases of finished goods.

(3) Purchases of consumable stores, fuel etc.

(4) Purchases of packing materials, etc.

(5) Purchases of articles like stationery for office use.

(6) Purchases for making additions to assets.

5.6.1 Special Precautions in Verification of Purchase Invoices

(a) When an invoice runs into several pages and the total of each page has been carried forward to the next or where the amount of an invoice has been distributed over several accounts, it should be confirmed that the amounts relating to different parts of the invoice have been adjusted together. When the total amount of the invoice has been adjusted in separate accounts, all the amount so adjusted should be added together to confirm that there has not been error under adjustment.

(b) At times, invoices are received in duplicate and even triplicate. In such cases, payment usually is made on the basis of the original invoice. Sometimes, however, the original is kept in record and the price is adjusted on the basis of the duplicate. In such a case, it should be confirmed that the original invoice has also been paid or adjusted separately.

(c) Often supplies are received on certain special conditions. In such cases, it should be verified that these are the same as were agreed to at the time the order was placed, *e.g.,* payment of freight and insurance charges of goods while in transit, etc. If the amount of an invoice was payable after the lapse of some time, subsequent to the receipt of goods, it should be ascertained that it has not been paid earlier and the benefit of cash discount, if any, has been obtained. Where a trade discount has been deducted from the amount of the invoice, it should be seen that only the net amount has been credited to the supplier.

(d) Where goods have been purchased for the use of an officer or a subordinate but the invoice is made out in the name of the concern for obtaining the benefit of trade discount, it should be seen that the cost has been charged to the person concerned and not to the Purchases Account.

(e) Purchases of goods from the allied and associated concerns can be made only under an appropriate sanction.

(f) If the case of an invoice addressed to an individual, particular care should be taken when vouching such an item, since the individual may have attempted to procure goods for his own use while allowing the company to pay for them. The system of internal check for purchases should be such as to preclude such a possibility. Nevertheless, it should be seen whether the goods are of a type which the company usually requires, and whether the invoice has been duly checked by some one other than the individual to whom it was addressed.

The delivery note and the goods inward note should be examined and it should be seen that the goods were inspected on arrival. Further evidence should also be sought to establish whether the goods were actually received into stock. The original order for goods should have been duly authorised by a responsible official. The firm supplying the goods should be requested not to submit invoices addressed in this way.

(g) If materials are bought for delivery direct to a customer, the exact circumstances of the transaction should be ascertained and the reasons for the goods having been delivered direct to the customer. The auditor should make appropriate inquiries in order to establish that the transaction was appropriately authorised by a responsible official. A copy of the delivery note signed by the customer on delivery of the goods should be examined, and it should be ascertained whether the customer is a regular purchaser of the company's goods and not an employee of the company wishing to take advantage of a weakness in the system. The original order should also be seen to have duly authorised by the appropriate official, and if this practice is a regular feature of the company's mode of transacting business, the system of internal check should be such as to ensure that no fraud may by perpetrated as a result of this practice. The payment for the goods, if it has been received, should be vouched to the cash book and bank statement.

(h) Though it is not practicable for an auditor to verify that every item of goods purchased has been entered in stock, he should trace into the stock record at least purchases of goods during the opening and closing months and accept the correctness of the rest only if he is satisfied that there exists a system of internal control which prevent payment being made for any goods not received in stock.

5.6.2 Failure to Check Stock

Some of the frauds which audit may fail to disclose unless stocks are checked are the following:

(a) Suppose there are two cotton mills : Alfa and Beta, and have a common managing director. The mill Alfa closes its accounts on December 31, and mill Beta, on March 31. Further, suppose that when the accounts of Mill Alfa for the year ended December 31, 2000 are prepared in January 2001, the managing director of the mill decides to transfer a part of the profits earned to mill Beta

To give effect to such a design, mill Alfa enters into an agreement in February 2001, with mill Beta but ante-dates the agreement to November, 2000. It provides that mill Alfa shall purchase 5,000 bales of cotton at Rs. 195, per bale from mill Beta. On the basis of this agreement a book entry showing that 5,000, bales have been purchased in November, 2000, is recorded in the books of the mill Alfa for the year ended 31st December, 2000, and their price is credited to the account of mill Beta, corresponding entries are recorded in the books of account of mill Beta. In pursuance of the entry 5,000 bales of cotton are included in the closing stock of mill Alfa valued at Rs. 190 per bale, the supposed market price. As a result the profit of mill Alfa are reduced by Rs. 25,000.

Subsequently on 28-2-2001another contract is entered into by mill Alfa to sell 5,000 bales of cotton to mill Beta Rs. 185 per bale. The corresponding entries are duly recorded in the books of mill Beta. The net effect of both of these entries is that the profits of mill Beta are increased by Rs. 50,000 for the year ended 31-3-2001and those of mill Alfa, for the year ended 31-12-2000 are reduced by Rs. 25,000 and by the same amount those of the year ended 31-12-2000 also. In fact, neither any bales of cotton are received by the mill Alfa from mill Beta nor they are sold back to Beta. Also neither any price is paid by mill Beta on purchasing the bales nor any sale price is received on the bales being sold back.

Students will observe that the foregoing transactions have been represented merely by book entries, as contemplated by clause (*b*) of Sub-Section (IA) of Section 227 of the Companies Act, 1956. Such a fraud may not be discovered, unless the auditor checks entries of purchases and sales of the bales of cotton in the stock books of the respective mills or carefully takes note of the associated nature of the companies and diligently scrutinises transactions of the subsequent period.

(b) A commercial concern dealing in mill stores enters in its accounts several invoices showing that it has purchased mill stores from a number of suppliers. All the purchases have been made for cash and the entries are duly supported by printed invoices showing the names and addresses of the suppliers that are false. All the payments have been

duly acknowledged by the parties. The auditor of the concern, not suspecting any *mala fides,* accepts the invoices as correct without tracing the purchases into the stock book. In fact, no mill stores had been purchased and the transactions entered into merely to reduce profits. The fraud remained undetected due to the failure of the auditor to trace the purchases into the stocks of the concern and preparing a stock-tally of goods purchased and sold.

(c) There have been several cases in the past wherein it has been found during liquidation proceedings that the management has overvalued its closing stock to show a profit larger than what the company has actually earned. In all these cases, fraud would have been detected if the auditor had verified the quantities and value of stocks at the close of the year.

All these cases related to the period before the Companies Act was amended in 1956. Therefore, the auditor escaped liability for professional misconduct. Until then it was possible for the auditor to accept the value of stock declared by the management. But this is not possible now. Under the present circumstances, a duty is cast on the auditor to verify the closing stock in the manner stated in Chapter 6.

5.6.3 Gross Profit

(i) *Factors which increase the gross profit* :

(a) Undervaluation of opening stock; it may be either the effect of non-inclusion of certain items of stocks or that of valuation of the stock at a rate lower than that warranted by the basis of valuation adopted or miscalculation of the value of one or more items of stock. In such a case, the increase in the rate of gross profit would be preceded by a fall in the rate of gross profit in the previous year.

(b) Overvaluation of closing stock, either by the inclusion therein of fictitious items of stock or over-statement of values of some of them.

(c) Alteration of the basis of valuation of closing stock, e.g., where the opening stock was valued at cost or market rate whichever was lower, valuing the closing stock at the market price which is higher than cost.

(d) Increase in the values of some of the items included in the opening stock (which were valued at market rate which was lower than cost) above cost, on account of which the unsold stock of the these items at the close of the year is valued at cost.

(e) Under-statement of opening stock or over-statement of closing stock, due to adjustment of the amount of sales, when goods sold but not delivered are included in the closing stock or when goods were delivered and taken out of stock last year, but sales invoices are raised in the current year.

(f) Entry of fictitious purchases to boost up profits. If such a practice has been resorted to, it would have the effect of reducing the rate of gross profit in the ensuing year.

(g) Inclusion in the closing stock of goods returned awaiting despatch to supplier, the cost of which has been debited to them or goods returned by customers, the cost whereof has not been credited to parties.

(h) Inclusion in the closing stock of goods received for the sale on approval or on a consignment basis.

(i) Treatment of goods sent out for sale on consignment basis as regular sales.

(j) No provision or under-provision in the expenses accounts included in the Trading Account. For example, purchase may be understated, provision for outstanding wages or carriage inward may not have been made.

(k) Wrong allocations of expenses, *e.g.,* carriage inwards either in whole or in part may be wrongly taken to the Profit and Loss Account.

(ii) *Factors which decrease the gross profit:*

(a) Over valuation of the opening stock or undervaluation of closing stock either due to mistakes made in taking stock or in its valuation.

(b) Alteration of the basis of valuation of stock, e.g., closing stock having been valued at cost, which is below the market price, when the opening stock was valued at market price above cost.

(c) Inclusion in the year of the amount of goods purchased in the previous year, that were received and where taken in the same year.

(d) Reversal of the fictitious sale entries recorded in the previous year to boost up profit.

(e) Entry of sales returns twice or failure to account for purchase returns when the goods in question have been sent back.

(f) Excessive provisions have been made for wages or direct expenses.

(g) Failure to include in closing stock goods sent out for sale on approval or on a consignment basis.

(h) Omission to adjust the value of unused stock of consumables stores, such as fuel and packing material or inclusion in Trading Account expenses which should have been included in the Profit in the Loss Account.

(i) Failure to take credit for the amount of an insurance claim in respect of a consignment of goods lost in transit or destroyed by fire.

(j) Failure to account for goods sold or destroyed or given away as samples.

From the aforementioned statement of factors affecting gross profit, it would be evident that it is affected by every failure to properly account for values receivable and payable at the time a benefit accrues or is given away. Such a position can arise in a multiplicity of situations, only some of which have been listed above.

The auditor must also take steps to verify that the amount of profit has not been overstated, *e.g.,* by the inflation of sales or closing stock, by understatement of purchases and expenses or by omission to credit customers's accounts with the value of goods returned by them, etc. The figure of profit can also be inflated by the failure to provide for losses and depreciation or reduction in their value, for instance, by not making adequate provisions for bad debts, for discounts payable on the recovery of book debts or for any fall that has taken place in the value investments or stock accounts would not disclose a true and fair state of affairs of the business.

Likewise it should be verified that profits have not been understated. As per Part III of Schedule VI to the Companies Act, 1956 a provision which is in excess of the amount considered reasonable by directors must be treated as a reserve. In consequence, any provision for bad debts, depreciation, expenses or liabilities which is in excess of the sums considered reasonable will be treated as reserve.

5.6.4 Purchases Returns

If a part or whole of a consignment of goods found to be defective or of a poor quality, the goods sometime are returned to the supplier and his account is debited. The debit is raised in the Purchase Returns Books, on the basis of Debit Note. The supplier, on receiving the Debit Note, issues Credit Note indicating his acceptance of the debit. Thus on receipt it is attached to Debit Note. All these entries should be verified by reference to the record kept in the Goods Outwards Book or the Stores Record. The original invoices through which the purchases were made also should be referred to for confirming that the nominal account, which was originally debited on the purchases being made, has been subsequently credited on a part or whole of the goods contained in the consignment having been returned. Where the purchase returns are large, either at the beginning or at the close of the year, these might be fictitious, entered to cover bogus purchases recorded earlier. On such a consideration the nature thereof should be ascertained. The rebate in price and allowances granted by the suppliers should be adjusted through the

journal on the basis Credit Notes received from the suppliers. These should be verified by reference to the original invoices.

5.7 SALES

The student should refer to Spicer and Pegler's book for the details in the matter of internal check on sales that should be exercised and the extent to which checking of individual entries in the Sales Day Book can be dispensed with when it is proper and effective. The credit sales should be verified by reference to copies of invoices issued to customers and, in the process, attention should be paid to the following matters :

(a) that each item of sales relates to the period of account under audit;

(b) that the goods are those that are normally dealt in by the concern.

(c) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Despatch Note showing the date and mode of despatch of goods are attached with the invoice.

(d) that the amount of the invoice has been adjusted in an appropriate account; and

(e) that the sale has been authorised by a responsible official and in token thereof he has initialled the invoice; also that any alteration in the invoice has been attested by the same person.

It should be generally verified that the sales have been made at a uniform rate, and on identical terms as regards payment of freight, sales-tax, packing, forwarding charges, etc. The additional charges recovered along with the sale price should be credited to separate accounts, appropriately headed, and not to the Sales Account. When a trade discount is allowed, the amount thereof should be deducted from the sale price. Where any special trade discount has been allowed, the reason thereof should be ascertained. The different types of sales should be classified under the following heads :

(1) Sale of raw materials.

(2) Sale of finished goods.

(3) Sale of empties and other packing materials.

(4) Sale of assets.

Small concerns generally do not have well organised Sales and Despatch Departments. In such cases, for verifying sales the auditor should trace a small proportion of sales invoice into the Stock Book, specially of goods sold at the beginning and at the close of the year. Such a step is essential for verifying that the sales of goods issued in the previous year or years have not been adjusted in the accounts of the year under audit, also that the goods

sold during the year have not been erroneously included in the closing stock. This would also disclose any bogus sales debited to the accounts of fictitious customers for which payments have not been received. In the case of sales to directors as well as to associated concerns, it should also be verified that these have been made at market rates. The sale of goods on hire-purchase basis of the goods sent out on sale or return basis or on consignment basis should be separately recorded. When credit sales are not adjusted in the accounts at the time they are made but at the time the sale proceeds are collected, there can be no guarantee that any amount collected in such sales has not been misappropriated. The auditor should, therefore, draw the attention of the management to the risk involved in adopting such practice; also in such a case he should not certify the correctness of any amount outstanding for recovery shown in the Balance Sheet in the absence of confirmation of the balance by the customers.

Clause (3) of Part II of Schedule VI to the Companies Act, 1956 requires that the total amount of sales for the year with a break-up for each class of goods dealt, in the related quantities, the selling agent's commission, brokerage and discount on sales other than usual trade discounts and the commission, brokerage and discount on sales other than usual trade discounts and the commission of sole selling agents should be separately disclosed in the Profit and Loss Account. The auditor should see that a separate record in respect of these items has been maintained for purposes of disclosure.

5.7.1 Goods Sent Out on Sale or Return Basis

A record of goods sent out on sale or return basis should preferably be kept in a specially ruled Day Book. In this book first memoranda entries are made; and only after the goods have been sold entries are made debiting the party and crediting the Sales Account. The auditor should refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited, also that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited. Further, that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year, has been included in the closing stock.

5.7.2 Sales Returns and Allowances

From time to time accounts of customers are credited with the value of goods returned and the rebates and allowances sanctioned on one account or another. The entries are passed on the basis of credit notes issued to customers. The credit note contains com-

plete particulars of the credit allowed and the basis on which it has been allowed. In each such case the auditor should verify that credits for goods returned have been allowed on the basis of the record maintained in the stores in respect of goods received back in the Goods Returned Book; also that rebates and allowances have been allowed in accordance with the policies and practices of the business. To verify credits in respect of goods returned, the auditor must check entries in the Goods Inward Book kept at the factory gate. He must further verify, on a reference to the memo, prepared when the goods were returned, that the goods in fact were defective and the defect was not one which occurred subsequent to the case on which the goods had left the factory premises. If such a memo is not on record, the management should be advised that a responsible official should examine the goods on their return and prepare such a memo.

When there is long time lag between the date of the sale that of return of the goods, the reasons for the same as well as the conditions, in which the goods have been received back should be ascertained. For it could be that the customer had returned the goods on its price having fallen, on one or the other pretext with the connivance of the sales staff.

The credit given to allied or associated concerns on account of goods returned by them should be specially examined to verify that the goods have been returned due to some valid reasons and the credit does not represent the reversal of fictitious sales earlier entered in their account. Allowances are granted to customers of a number of reasons; goods having been supplied short or goods having suffered damage while they were in transit, some defect in their quality, etc. The auditor should verify that these have been granted under a proper authority and on a due consideration of a claim and of the policies of the business in these matters. If considered necessary, correspondence with the party, the quantities and value of goods supplied and those returned out of them also should be verified.

We have considered earlier how a dishonest book-keeper might misappropriate the amounts received from customers by entering false credits in their accounts on account of rebates and allowance on the return of goods. This possibility should be kept in view while verifying the aforementioned credits.

5.7.3 Empties

When the empties or containers in which goods necessarily have to be supplied are costly, the manufacturers normally agree to purchase them back at a reduced price as compared to the one charged for them. In such a case, it is necessary to keep a separate account of the empties “issued and received” and the number of them held by the

customers, which they may return after the close of the year. The auditor should see that this has been done and also that a provision has been made against the contingency of the containers being returned by customers and that for the wear and tear which they would suffer in the process.

5.7.4 Consignment Sale

Where the number of consignments sent out in a year is large, usually a separate consignment Sales Day Book and Ledger are kept. In that case, the entries in the Day Book in respect of price of goods sent out and expenses incurred on their transport and insurance should be verified with copies of proforma invoices and other relevant documents; the sale price of goods sold and expenses incurred by the consignee should be verified from the Account Sales.

The balances in the Consignment Ledger, at the end of the year in such a case, would represent the cost of unsold goods, including a proportion of non-recurring expenses incurred on their transport and insurance. These balances should agree with those shown in the respective account sales received from the consignees.

If the goods sent out for sale on consignment have been charged at the invoice price, the difference between the cost and the invoice price would be credited to the Consignment Stock Adjustment Account. The appropriate part of the amount credited in this account attributable to the stock remaining unsold at the year end, should be reversed so that credit can be taken for the net amount representing the difference for the part actually sold.

5.8 CUT-OFF ARRANGEMENT

Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separate from those in the ensuing period so that the results of the working of each period can be correctly ascertained. The arrangement that is made for the purpose is technically known as “Cut-off arrangement”. It essentially forms part of the internal check of the organisation. Accounts, other than sales, purchases and stock are not usually affected by the continuity of the business and, therefore, this arrangement is generally applied only to the aforesaid accounts. The auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that :

(i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and

(ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and after the cut off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking.

5.9 AUDIT OF LEDGERS

5.9.1 General Considerations

The audit of ledgers generally involves the undermentioned steps :

(i) Testing the strength and quantity of internal check;

(ii) Tracing the opening balances from the previous year's records;

(iii) Checking the postings from subsidiary books and, if they are kept on the self-balancing system, also tallying the totals of balances in subsidiary ledgers with those in the total of control account;

(iv) Checking the closing balances of individual accounts on the balance schedules afterwards from the schedules on to grouping schedules and then into the final accounts;

(v) Checking the totals of ledger accounts, trial balance, schedules and groupings;

(vi) Verifying the balances in personal accounts, either with the statements of account or confirmation of balances obtained from the parties; verifying the balances in impersonal accounts, *viz*., those of fixed assets, bank balances, etc. with the schedules containing details of assets and liabilities as well as those of nominal accounts (featuring various items of income and expense by reference to the documentary evidence which may exist in a variety of forms to ensure that all the outstanding amounts, both receivable and payable have been properly adjusted);

(vii) Scrutinising the accounts generally and, in particular, examining the composition of final balances; and

(viii) Ascertaining the extent of clearance of the balances brought forward from the previous year particularly those relating to receivables and payables, sale or disposal of fixed assets and of inventories.

The audit of ledgers is thus an important step in the process of verification of the correctness of Final Accounts. It is an occasion to review the transactions entered during an accounting period, duly classified, in the totality; also that of studying the relationship

which exists between different sets of figures. Ledgers, therefore, should be examined carefully and comprehensively. The composition of the balance of each account should be scrutinised and, if a doubt arises, the transaction or the set of transactions, which have given rise to the doubt should be examined in depth.

When a comprehensive and effective system of internal control exists, it is possible to limit the routine checking of ledgers by the application of test checks as stated below :

(i) verifying the postings into the ledgers from the various books of prime entry;

(ii) verifying the totals of the account;

(iii) tracing the balances of the personal and nominal accounts from the ledgers into the schedule of balances ;

(iv) comparing schedules totals with the balances in the Control Accounts; and

(v) checking the position of the daily entries into Control Accounts.

The foregoing audit tests be applied to a selected group of entries in the ledgers. Alternatively, steps (*i*) to (*iv*) should be applied to accounts for parts of the year determined on a selection. However, the posting of the Control Accounts should be verified for the whole year. In selecting the period or periods of verification of posting and totals, preference should be given to the accounts the composition whereof is not clear or in which items on either side cannot be correlated. Moreover, instead of certain periods being selected for the application of test checks, a few accounts could be selected for being test checked for the whole of the year.

If, however, the system of internal control on application of procedural tests is found to be ineffective, it would be necessary for the auditor to extend the programme of verification of balances of the accounts in the ledgers as aforementioned. In doing so, the auditor should take into account the existence of possibilities of frauds being committed through manipulation of entries in the ledgers, for example, the possibility of the ledger clerk colluding with others for misappropriating amounts collected from the customers and subsequently covering up misdeeds by adjusting fictitious credit in the customer accounts.

Such a fraud in a ledger would not be disclosed merely on extracting balances from the ledger and agreeing their totals with the balance in the respective Control Accounts, since the balances, despite the fraud, would agree. It would be discovered either on postings being checked in detail, or on obtaining detailed statements of account from customers and comparing them with those stated in the books of account.

5.9.2 Ledger Keeper and Frauds

For studying the various avenues which are open to a ledger-keeper to commit a fraud, the auditor should find out whether the ledger-keeper extracts balances of customers and creditors from the ledgers and agrees their totals with their balances in the Total Accounts; also whether the balances when they have been extracted, are subsequently checked by some other official; further, whether he has access to the debtors and creditors; also if he meets them, does he do so on his own or in the presence of responsible official?

Some of the frauds which may be committed by a ledger-keeper are stated below :

(i) *In the Bought Ledger :*

(a) Crediting the account of a supplier on the basis of a fictitious invoice, showing that certain supplies have been received from the firm, whereas in fact no goods have been received or on the basis of duplicate invoice from a supplier, the original amount whereof has already been adjusted to the credit of the supplier in the Bought Ledger, and subsequently misappropriating the payment made against the credit in the supplier's accounts.

(b) Suppressing a credit note issued by a supplier in respect of return or an allowance and misappropriating an amount equivalent thereto out of the payment made to him. For if a credit note issued by a supplier either in respect of goods returned to him or for an allowance granted by him, is not debited to his account, the balance in his account in the Bought Ledger would be larger than the amount actually due to him. The ledger-keeper thus will be able to misappropriate the excess amount standing to the supplier's credit.

(c) Crediting an amount due to a supplier not in his account but under a fictitious name and misappropriating the amount paid against the credit balance.

(ii) *In the Sales Ledger :*

(a) Teeming and lading method. This method has been explained in Chapter 3.

(b) Adjusting an unauthorised credit or fictitious rebate, allowance, discount, etc. in the account with a view to reduce the balance and when payment is received from the debtor, misappropriating an amount equivalent to the credit.

(c) Writing off the amount receivable from a customer's bad debt account and misappropriating the amount received in payment of the debt.

(iii) *In the Nominal Ledger :*

(a) Allocating an item of income or expenditure wrongly, e.g., an item of capital expenditure being charged as revenue and vice versa; and

(b) Understating or overstating the value of stocks, amount of prepaid expenses or liability.

Verification of Posting :

(a) The selection of accounts for checking postings should be made on the same consideration as that accounts, the balances whereof require to be confirmed directly as stated hereinafter. Moreover, either all postings should be checked for only a part of the period covered by the audit or only a few accounts selected for the whole period.

(b) Subsequently, when the closing balances in a ledger are checked, it should be confirmed that postings in the ledger to the extent specified in the Audit Programme have been checked; also that the totals of the balances have been checked. If there is any item in any account in a ledger, the posting whereof has not been checked indicated by absence of the relevant tick against the item, the reason thereof should be ascertained.

(c) Each ledger account should be seen through to confirm that all the entries therein are posted in a chronological order; no entry has been made in between two entries and the figures of an entry have not been altered; also that there is no entry which has been posted directly into the ledger before being recorded in a book of original entry. In each such case, the genuineness of the entry or entries should be verified, for these could be the results of attempts made by the ledger-keeper with an ulterior motive.

Finally, it should be confirmed that all the ledger balances are linked. As a safeguard against the ledger-keeper making an entry in a ledger after the same has been checked, it is usually advisable that until the audit has been completed all the ledgers should remain in the custody of the auditor. The opening balances should be checked, wherever practicable, with the balances shown in the auditor's own copy of trial balance, schedules and groupings of the previous year. Alternatively, these should be checked with the balances shown in the Balance Sheet, as at the end of the year.

While checking the closing balances or the groupings of balances, a memo should be prepared as regards particulars of various balances which need to be disclosed in the Balance Sheet, as well as of matters in respect of which either sanction has to be obtained or adjusting entries have to be passed.

5.9.3 Scrutiny of Ledgers

(i) Bought Ledger : The structure of every account in the Bought Ledger is : opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers. Usually, it is possible to link up each amount on one side of the account, with one or more accounts on the other side; only the amounts which cannot be correlated require a detailed scrutiny. Generally, it should be verified that payments for goods have not been made long before they were due; nevertheless, they have been made within the period of credit, to take advantage of the cash discount allowed by the supplier. The scrutiny of the accounts would show that payments for goods normally have been credited in the order in which their costs have been credited in the accounts. Therefore, if in any case no payment has been made against the opening balances or against any particular item of credit, the reasons thereof should be ascertained. Likewise, credit entries which cannot be correlated with those on the debit side should be enquired into to confirm that they are not fictitious.

It should be further seen whether full payments for purchases have been made at a time or in parts. In the cases where payments have been made in parts, the reasons for such a practice having been followed should be ascertained. Further, when payments to a supplier are usually made by accepting Bills of Exchange but one or more amounts have been paid in cash, the reasons therefor should be ascertained. It would be observed that in respect of goods returned back, as well as allowances allowed by the supplier, either separate payments have been received or the amounts therefor have been deducted out of subsequent payment made for goods purchased. Where this has not been done, the reasons should be ascertained.

The accounts in the Bought Ledger, usually, are in credit. The composition of the balance of each amount should be scrutinised. If it is not clear, reference should be made to the account of the party as shown in the ledger for the previous year or in the one for an earlier year. The composition of each balance will indicate the group in which the balance in the account should be included for statement in the Balance Sheet. When the amount of the opening balance of the account of the cost of goods purchased earlier has not been paid but the goods purchased subsequent thereto have been paid, the reasons for the non-payment of the amount or amounts should be enquired into. It could be that the liability to pay the amount is disputed or is totally denied. The auditor should examine these claims to assess the liability of the client and may then have the balances adjusted and disclosed accordingly. If the liability is totally denied, the amounts should be written back. But when it is partially admitted, these should be reduced to the extent admitted.

If the account of a supplier has been credited at the end of the year with large sums of money, the basis of the credit should be enquired into as it might be a fictitious credit with a view to suppressing profits. If certain goods purchased from a party have been subsequently sold back to him, enquiries should be made to find out if the transactions of the purchase and sale are not mere book entries, hit by Clause (*b*) of sub-section (IA) of section 227 of the Companies Act, 1956. When a balance in an account has been outstanding for payment for an inordinately long time, enquiry should be made to confirm whether the balance in fact is payable.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule VI to the Act. The maximum account due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed alongwith the names of companies (Part I, Schedule VI to the Companies Act, 1956).

Students may note that in view of section 296 of the Companies Act, 1956 a loan or an advance paid to a director, which from its inception was in the nature of a loan is to be regarded as a loan falling within the purview of section 295.

(ii) Sales Ledger : The structure of each account in the Sales Ledger is opening balance, debits representing values of goods sold, payments made for goods returned and transfers. The credits represent amounts received for goods sold, advances received against orders, discounts and allowances allowed, value of goods returned back and

debts written off. If amounts on either side of each account are checked with the corresponding amounts on the other side, the discrepancy, if any, would be discovered.

It should be seen that the customers' balances are being collected promptly, otherwise the capital of the client would locked up unproductively; also the risk of bad debts and misappropriations would be greater. Therefore, when the examination reveals such a position the auditor should bring this fact to the notice of the management.

If, during the course of examination, it is found that the opening balance in an account or an amount of sales has not been collected, while the amount of sales made subsequent thereto have been duly recovered, it could be that the customer is disputing the liability to pay the amount or that the cash collected in payment of the amount has been misappropriated. It may also be found that the debit balance in an account has been collected in parts. It could be the result of misappropriation practised by the teeming and lading method. All these matters, when noticed, should be fully investigated.

When the payments for sales to a customer have been received in parts, it would be beneficial for the client to adjust the amounts received against amounts which have been outstanding the longest. The auditor should confirm that the client is aware of it and has acted accordingly.

Where it is discovered that the returns out of sales, made in the year or years, have been adjusted in the accounts during the year under audit, the justification for such a delayed adjustment should be enquired into, for it could be that the customer has been allowed to return the goods, only as a matter of favour. Likewise credit balances resulting from the allowance of discounts and rebates should be scrutinised to confirm that these have been availed of within a reasonable time. If any allowance has been adjusted against an amount recoverable for the goods sold, it should be verified that the allowance is not fictitious, for it could be one which has been adjusted by a dishonest book-keeper with a view to covering up a fraud committed by an employee, by misappropriating the cash collected from the customer.

While checking the customer's balances, the auditor shall have an opportunity to comprehensively review all the transactions entered into with each of them. If, in the process, he finds that there are any old balances which have not been collected, the possibilities of an amount collected having been misappropriated should be investigated. For the purpose, the auditor should obtain from the customer either confirmation of the balances or copy of his statement of account, admitting that the amount is infact payable by him.

If a sale has not been recorded, though the ledger account would not contain an entry in respect thereof, it may contain an entry showing that a credit for the goods returned or an allowance has been adjusted in his account which has been paid to him in cash. This would show that the original sale has not been recorded. Such a discovery may lead to the unearthing of an organised scheme of fraud.

A clever employee who has misappropriated an amount paid by a customer might attempt to adjust the debit in the customer's account before the close of the year by paying in a bogus cheque. The cheque, no doubt, would be received back unpaid in the beginning of the next year. But the non-payment of the cheque would not be detected until the bank account is reconciled. Therefore, when the bank reconciliation statement shows that the cheque of a party has been received back unpaid, the auditor should find out whether the amount due from him has been or will be recovered.

If the amount paid by a debtor has been misappropriated, though the balance in the account would be outstanding for payment, it would not be recoverable. It is only on this consideration that there exists an audit practice according to which confirmation of balance is obtained from debtors and creditors directly at the close of each period.

If the balance in an account has been settled for a smaller sum, the nature of the dispute and the amount which the client has agreed to forego should be ascertained. In case the dispute has been settled by arbitration, the award should be referred to.

All transfers of balances from one account to another should be checked to confirm that these have been made under proper authority in the normal course of the business.

If the scrutiny of the account in the Sales Ledger shows that any of the book debts is not recoverable, the auditor should confirm that an adequate provision has been made against the same.

To verify the adequacy of provision against bad and doubtful debts, usually the client is asked to prepare a list of debts which are irrecoverable either wholly or partially. All the balances in the list afterwards are scrutinised by the auditor to confirm that these are in fact so, also that adequate steps have been taken by the client for their recovery but without success or that they are time-barred for recovery. It is necessary to remember in this connection that debts can be written off only under the authority of a person who is empowered to give up a claim, *e.g.*, board of directors, partners or the proprietor.

When any bad debt is written off, the client should be advised that a record thereof should be kept in the Bad Debts Register in order that if subsequently any recovery is made out of it, may be possible to identify the amount.

Finally, the composition of all balances outstanding of recovery should be examined. Normally, the debit balances in an account should be the total of the amount of sales not collected. In every case, where the composition of a balance is not clear, the copy of the statement of account received from the party should be referred to . If in respect of a particular customer, copies of a number of invoices are not in record his balance should be confirmed by sending out statement of account.

While checking the closing balances which are required to be included under certain specific heads of account, those required to be separately disclosed (*e.g.*, amounts due from Directors, Managers, or concerns in which they are interested) should be listed up separately.

For the tests, which must be applied and the enquiries which should be made for ascertaining which of the customer's balances are bad and irrecoverable, students may refer to the next chapter.

NOTE : ***Self-balancing and sectional balancing ledgers*** : When in an organisation a number of ledgers are maintained, it is usual to find the system of self-balancing or sectional balancing of ledgers in operation. Sectional balancing, as any student of accountancy knows, is just the system of maintaining a total account in the general ledger in respect of each sectional ledger like debtors, creditors, nominal accounts. The self-balancing system is a further improved system which enables the preparation of independent trial balances for each of the separate ledgers by means of contra-adjustment accounts. This, as part and parcel of the system of internal check, is of great assistance to the auditors for localising errors. It should however be borne in mind that the only reliable verification of balances of various adjustment accounts in the general ledger lies in the thorough verification of the various personal ledger balances. As regards the routine checking aspects, no special technique is involved. The postings to the individual ledgers and to general ledger account maintained for control purpose should be appropriately checked. Also the castings and balancing should be tested.

(iii) General Ledger : The general ledger contains all the balances which are ultimately included in the Profit and Loss Account and the Balance sheet. Its examination, therefore, is undertaken last of all. It should be carried out with great deal of care inasmuch as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.

Entries in the General Ledger usually are posted in a summary form from the Cash Book, Journal, and from other subsidiary books like Purchases Book, Sales Book, etc. As such before starting its examination, it should be confirmed that all the postings in various

accounts have been verified, totals have been checked and the final balances have been linked.

It should also be ascertained that balances in all the income and expense accounts have been adjusted: (*i*) according to standard accounting practices, and (*ii*) on a consideration of the legal provisions which are applicable to the concern. Each ledger balance finally should be examined on a consideration of its position in the Final Accounts to see how the financial position of the concern would be affected by the inaccuracy in the balance.

Wherever practicable, the balances in the General Ledger should be traced simultaneously on to the trial balance, the groupings schedules and the Final Accounts. At the same time, by way of a comparison, the corresponding balances in the previous year's Final Accounts also should be referred to.

It should be confirmed that the accounts have been kept according to accepted accounting principles and the Balance Sheet and the Profit and Loss Account have been drawn up on the same basis as in the previous year.

Students' attention in this connection is invited to Clause 3 (xv) of Part II of Schedule VI to the Companies Act. It requires that for any item shown in the Profit and Loss Account, affected by any change in the basis of accounting, the amount involved should be disclosed. Consistency is also one of the fundamental accounting assumptions as stated in AS-1 on "Disclosure of Accounting Policies". Usually, the accounts of a commercial concern are kept on the mercantile basis. It demands that all the liabilities in respect of goods purchased or expenses incurred before the close of the year that were outstanding for payment should be provided for; amounts paid as advances should be included as an asset, the proportion of expense relevant to the period that extends beyond the close of the year should be excluded by the amount being debited to the prepaid Expenses Account. Further, on the same consideration, the income which had accrued before the close of the year, but had not been collected should be taken credit for and correspondingly, income relating to the period, following the close of the year, which has been received in advance should be adjusted as a liability. Thus, unless accounts are adjusted in this manner, neither the Trading and Profit and Loss Account nor the Balance Sheet would disclose a true and fair state of the business.

The valuation of assets and verification of liabilities are other important steps in the ascertainment of profit earned by the business inasmuch as only under or overvaluation thereof would either depress or boost up profits.

Conventionally, current assets are valued at their cost or net realisable value whichever is lower, fixed assets are valued at cost reduced by the amount of depreciation that they have suffered, calculated on any accepted basis, and followed consistently.

(iv) Main Journal : Both the closing and adjusting entries as well as other entries which cannot be accommodated in any other Journal are recorded in the Main Journal. The evidence in support of entries in this Journal usually exists in a large variety of forms. It may consist of correspondence, contracts, minutes of Board of Directors or the shareholders, statements of account, etc. All the statements attached to support adjusting entries, since these would be prepared by the internal staff, should be verified very carefully, and where possible, some independent evidences in confirmation thereof should be obtained.

The correcting entries will contain references to vouchers which have already been checked by the auditor. He ordinarily, therefore, will have a record thereof in his audit notes. It should be referred to while verifying them. One form of adjusting entries is the one recorded to provide for expenses accrued till the date of the Balance Sheet but not paid, *e.g.*, those in respect of rent, electricity, income-tax, etc. as well as for taking credit for the income accrued but not received, *e.g.,* interest accrued which is not matured for receipt, lease rent accrued which is not due for payment, etc. In all such cases, it is possible that by the time that audit is undertaken, some of the liabilities, a provision for which has been made, may have been paid off; also that the amounts adjusted as not recoverable may have been collected. As a result, in actual practice, it may be found that amount paid or received were larger than those adjusted. But so long as these were estimated on a reasonable basis, it is not necessary for the auditor to reopen accounts to adjust the difference between the amounts of income or expense estimated and those collected or paid.

The opening entries should be verified by reference to the balance sheet or other similar documents for the previous year.

The auditor should specially note that neither any accounting principles nor practices followed in the past have been contravened or altered during the year under audit. If a departure has been made, its effects should be disclosed on the face of the Profit and Loss Account. For example, when the basis of valuation of closing stock or that for providing depreciation on fixed assets has been altered, their effect on profit should disclosed.

5.10 OUTSTANDING LIABILITIES

1. *Purchases* : In some instances, invoices relating to purchases of goods that have been taken into stock are received too late to be included in the Purchase Day Book of the closing month. As a result, those will be included in the accounts of the succeeding period. In such a case, a schedule of such invoices should be prepared and their total debited to Purchases Account and carried down as an outstanding liability. If the precise amount of liability on account of such purchases cannot be ascertained, an estimate made by a responsible official might be accepted.

2. *Wages, Salaries, etc.,* : The amounts debited to these accounts should represent the amount actually chargeable for the year. Thus, if the amount payable at the close of the year has been paid in the succeeding period, a provision therefor should be made. While doing so, it should also be verified that the corresponding provision made at the end of the previous year has been brought in as a credit, for arriving at the amount chargeable for the year.

3. *Rent and Taxes* : The amount charged towards the rent should be the annual rent as provided for in the lease. If any rent for the year was outstanding at the close of year or has been paid in advance, the amount outstanding or paid in advance should be adjusted as a liability or asset respectively.

Municipal taxes usually are payable in advance. As a result a proportion of last payment is usually carried forward as unexpired to the next period. By scanning the account, it should be ascertained that the charge only for the full has been included in the account.

4. *Directors' and Managing Directors' Fees or Salaries* : It should be verified that after making necessary provisions for account outstanding the total amount debitable to the account agrees with the resolution of the Board of Directors or shareholders under which the payments have been paid at the rates authorised by the articles in respect of meeting attended by the Directors and it should be noted that the working directors of a public company are not expected to receive any such fee pursuant to the guidelines issued by the Company Law Board.

5. *Freight* : Carriage and freight account may not be rendered till some time after the period to which they relate. In such a case a provision for the amount outstanding may be made on an estimate and while doing so the amount provided in the earlier year may be taken into account.

6. *General Expenses* : Entries in the various accounts should be carefully examined and analysed to make certain that no item has been debited in this account which should have gone elsewhere. Quite often, donations and subscriptions, bank charges, conveyance and other petty expenses are included under this head. Wherever possible, the use of such omnibus account for these debits should be avoided and, in any event, where the total of items in any individual class of transactions is considerable to warrant a separate account being opened for it, the same should be segregated and recorded in a separate account. When this is not possible, as a precaution an analysis of the account should be prepared at the end of the year and the total under the various headings compared with the corresponding totals in the previous period. Part II of Schedule VI to Companies Act, 1956, requires that every company must show under distinct heads the expenses that exceed 1% of the total revenue of the company or Rs. 5,000 whichever is higher. Henceforth, it would be improper to include any such expense under the heading "miscellaneous expenses" or "general expenses".

5.11 OUTSTANDING ASSETS

There are two classes of outstanding assets the adjustment where of has to be examined; first, items accruing but not recorded in books and second, expenditure already incurred, a part or whole of which relates to a period subsequent to the date of the Balance Sheet.

The following are some of the accounts in which adjustment of outstanding assets could be made:

(1) *Rent receivable* : All rents receivable due or accrued to the date of the Balance Sheet should be calculated and brought into account, after a provision has been made for doubtful or irrecoverable arrears of rent, allowance for repairs, etc.

(2) *Interest and dividend* : Interest receivable on loans accrued to the date of the Balance Sheet should be brought into accounts in all cases where the interest is being regularly received on the dates. If the interest is in arrears, the amount accrued should either be omitted or brought into account and a corresponding provision made against it. Interest on debentures and other securities, receivable on fixed dates accrued and payable before the close of the year should be brought into account and adjustment on account of dividend on shares should be made with reference to the dividend accounting policy followed by the management. This would be in order if the same is accounted for on the basis of declarations during the audit year. It is also possible to account for dividends declared after the close of the year, provided the period in respect of which the same was declared fell within the accounting period of the client. However, accounting of dividend purely on receipt basis would not always be in order for companies. Finally, it should be ensured that the methods in this regard have been consistently followed.

(3) *Insurance charges paid in advance* : Insurance premiums are always paid in advance; and, in case of a large business, the amount paid, the benefit of which will arise in the succeeding period, may be considerable. The proportion thereof applicable to the period subsequent to the date of the Balance Sheet should be calculated and included as an outstanding asset.

(4) *Advertisement* : Sometimes payments under advertising contracts are made in advance. In such a case, the proportion thereof relating to any period subsequent to the date of the Balance Sheet should be adjusted as an outstanding asset.

5.12 GENERAL SCRUTINY OF EXPENSE ACCOUNTS

The structure of each expense account should be thoroughly scrutinised and the distribution of the total expense over different methods comprised in the period under audit. Where there are significant variations between different months, the cause thereof should be ascertained. At times, it may be found that an expense account has a few credit entries. These may represent recovery of the share of common expenses from one or more participants, refund of rebate obtained from a supplier of an entry made to exclude the expense relating to the succeeding period. All these entries should be verified.

Some entities maintain an Outstanding Book, for keeping a record of expenses which were outstanding at the close of the year that have been paid in the succeeding years. From a reference to the entries therein, it is usually possible to have an explanation for the difference that there is an amount of expenditure paid out in the closing month as compared to that in the earlier months. The book is of much assistance also in the verification of the accuracy of the provision made for expenses which were outstanding at the close of the year.

While verifying the adjustment of liabilities, outstanding at the close of year, it should be observed that the liabilities, a provision for which was made in earlier years, have been paid off during the year, and if any amount has not been paid, reasons thereof should be ascertained, as it may not all be payable.

Where certain common expenses have been divided between two or more activities carried on by the same concern or between two sister concerns, it should be ascertained that the basis adopted for the division is reasonable.

Where there has been a change in the basis of accounting, as compared to that in the previous year, the reasons thereof should be ascertained and if any item is shown in the Profit and Loss Account has been affected by any change in the basis of accounting, the amount of the difference should be shown separately by way of a note.

The different elements of cost (material, labour and manufacturing expenses) generally are known as direct expenses. Normally, there exists a direct relationship between the cost of each element and total cost of manufacture of the article. Therefore, where there has been a significant variation in the relationship the reasons thereof should be ascertained. It may be due to some of the expenses having been left out or having been included in excess. This could be ascertained on a verification of the entries relative to adjustments of different types of expenses. The causes of variation in the proportion of direct expenses usually can be readily ascertained but this is not practicable in the case of indirect expenses, for these often are the result of a variety of factors unconnected with manufacturing process.

For instance, the change in indirect expenses may be the effect of the change in the rate of turnover or that in the structure of the management. Quite often office expenses increase with that in the rate of turnover, but they may not do so in proportion thereto. For example, if a business owned by a partnership is taken over by a company or machines are introduced to perform certain routine functions which were previously carried out manually, the cost of administration may increase. Small variations therein may also take place due to substitution of one form of expenditure by another either as a measure of economy or on consideration of good management. For example, a company may decide to raise a part of its working capital by issuing debentures and to pay off its overdraft account on which it was paying a higher rate of interest. The management may otherwise decide that local letters should be delivered by hand even though the cost of peon delivery is greater.

Normally, every increase in an expense is accompanied by that in income, *e.g.,* an increase in selling commission, freight and packing charges is usually the outcome of an increase in sales. At times, however, an item of expense may not immediately result in revenue. For example, the trip of managing director abroad to find a foreign market for the articles manufactured by the company may not start showing results until some time has passed.

The provision for liability that has been incurred, the amount whereof cannot be ascertained accurately, is generally made on the basis of an estimate. But where the existence of the liability is contested, the amount thereof is only disclosed as a contingent liability. Where, in the previous year, provision for an item of expenditure was either not made or was short and the difference in the amount was subsequently paid and the amount of provision is material, the fact should be disclosed by the amount being shown below the line or the amount being shown separately in a bracket against the amount of expenditure of which it forms a part.

5.13 INCOME ACCOUNTS

It is comparatively an easy matter to verify different forms of income earned by the client during the year in totality. In respect of some of the incomes which are collected regularly, *e.g.,* rents on lockers in the case of Safe Deposit Vault, dividends on shares, subscription in case of clubs, advertisement revenue in case of publishers of newspapers, a record of income the basis on which it has been collected and the particulars of the party through whom it has been received are contained in a Demand Register; there is a separate Demand Register for each such form of income. For the verification of such an income, it should be seen that the Demand Register has been checked and the balance that was outstanding for collection at the close of the year has been adjusted as an asset. In cases where the income earned represent charges for services rendered, the particulars of services rendered by the client to different customers would generally be recorded in a separate statistical register, *e.g.,* Job Register in case of the printer and Repairs Register in the case of a workshop, Patients Registering in case of a doctor, Clients Register in the case of solicitors, etc. By reference thereto it should be verified that the amount receivable in respect of services rendered before the close of the year have either been called or adjusted as an outstanding asset.

The sale proceeds of goods which have been sold at a uniform rate of gross profit, *e.g.,* boxes of tea, petrol, vanaspati, ghee, etc. can be verified by computing the amount of gross profit, which the firm should have earned on quantities of goods sold during the year comparing it with the amount actually earned.

In case of a manufacturing concern, the system of invoicing finished goods should be examined to confirm that the system of internal check in operation ensures that goods would be despatched only after they have been either paid for or the account of the purchaser have been debited. Also, the quantities of raw materials consumed during the period should be reconciled with the quantities of finished products manufactured. The rate of wastage, if any, should be compared with that in the earlier period. It should be verified that quantities of goods sold but not delivered in respect of which bills were not prepared before the close of the year, have been adjusted in the books.

For ascertaining the trading profit of a year, it is also necessary that profits from trading transactions which were not completed before the close of the year should be brought into account by allocating the total profits on a reasonable basis over the different accounting periods in which these will be completed. The auditor should therefore see that discounting charges of bills of exchange earned on such sales, profits on contracts not completed, etc., have been distributed over their periods of accrual on a “reasonable basis”.

Capital profit, *e.g.,* profit arising on sale of assets, reissue of forfeited shares, etc., not available for distribution as dividend, are credited to the Capital Reserve. Any transfer to Capital Reserve out of amounts credited to the Profit and Loss Account should be separately disclosed. Similarly, income of an extraordinary and non-recurring character should be separately shown in the Profit and Loss Account [Part II of Schedule VI, Clause (3)(*xii*)(*b*)].

5.14 ASSET ACCOUNTS

The general make up of fixed asset account is: opening balance, additional adjustment of profit or loss on sale and on account of depreciation.

Every entry which does not conform to this pattern should be inquired into it should be observed that expenses on current repairs have not been conversely those on additions to or renewal of assets have not been charged. It should be verified that purchase of assets or addition to them have been the sanction of directors or partners, as the case may be, also where the initially the whole of the undertaking has been sold, in the case of a come under the sanction of shareholders at general meeting.

Where the entire undertaking of a business had been taken over, the value placed by the management on different assets and particularly the amount debited to Goodwill Account or that credited to Capital Reserve Account, should be verified by reference to the vendors' agreement. The debit to the Goodwill Account would be necessary only when the amount paid for the business is in excess of the total value of asset taken over reduced by the amount of liabilities taken over. On the other hand, if the last mentioned amount is in excess, it shall be credited to the Capital Reserve Account.

The values of various current assets held at the close of the year and their composition should be compared with those held at the end of the previous year and if there is material change in their amounts or the basis of their valuation, the reasons thereof should be ascertained. If they appear to be unduly large, *e.g.*, when the value of stock in hand has doubled but the sales have not increased, the fact should be brought to the notice of the management.

It should be also verified that interest at reasonable rate has been charged on loans advanced to directors, managers, and all concerned; also that loans were advanced under appropriate authority either that of directors or shareholders.

The balance in the Suspense Account, if any, should be analysed and the constituent amount included under appropriate heads of the Balance Sheet.

Finally, it should be confirmed that assets have been properly grouped under different heads for purpose of disclosure in the Balance Sheet and the method of valuation of each asset is shown as required by the form in which the Balance Sheet is required to be presented.

5.15 LIABILITIES

The auditor should obtain a certificate from the client that all the liabilities which had accrued due till the close of the year have been taken into account and contingent liabilities, if any, have been fully disclosed.

It should be verified that the liabilities have been appropriately grouped under different heads for the purpose of disclosure in the Balance Sheet; secured and unsecured liabilities have been segregated; and against the first, nature of security and its amount have been stated.

5.16 BALANCE SHEET AUDIT

Until recently, test checks were applied only for confirming balances in a few nominal accounts; those of stocks and stores, amount of sale and other similar records relevant to trading transactions, which were voluminous but of similar nature. Now a days on account of increase in the size of business units, but more so due to mechanization of accounting, the test checks are being applied widely for the verification of income and expense accounts as well as assets and liabilities. This has crystallised into a form of audit known as Balance Sheet audit.

A Balance Sheet audit consists of the verification of all includible Balance Sheet items, together with the examination of expense and income accounts which are so closely related to these items that it cannot be properly verified without such analysis and test. Records, vouchers, books and accounts are examined; capital and revenue accounts are analysed. The concept of Balance Sheet audit has been developed along with the development of formal internal control system. In outline form, a Balance Sheet audit will include the following:

1. An examination of partnership agreement, the memorandum and articles of association, minutes of the board of directors, and the system of accounting in force, (depending upon the type of entity).
2. The establishment of ownership of all assets included in the Balance Sheet.
3. Proof that all owned assets are included.

4. The inclusion of the asset in the Balance Sheet is in accordance with the accepted principles of accounting.
5. Proof that all liabilities are included and at proved amounts.
6. The examination of adjusting and closing entries or any other entries necessary to the preparation of the Balance Sheet.
7. Evidence that the distinction has been made in recording transactions between capital and revenue; and that capital and revenue have been created on the basis of accepted accounting principles.
8. Proof that the share capital issues have been made in compliance with the requirements of law and they are correctly recorded in the financial books.
9. An analysis of the charges and credit to the revenue accounts and the inclusion of the resultant balance in the Balance Sheet.

Given below are some of the overall tests which may be applied for verification of balance in the Profit and Loss Account.

Expenses Accounts:

(a) Check direct expense such as customs duty, excise duty with the value of purchases and quantity of goods for sales; verify adjustment of regular expenses *e.g.* rent, managerial salaries, insurance charges, postage, stationery, etc.

(b) Compare the total of each expense account comprised in the Trading and Profit Loss Account with the corresponding amount in the same account for the previous year and if there is any material variation in any one of them, find out the reason therefor.

(c) Determine whether increases or decreases in wages, material consumed and variable expenses appear to be proportionate to the increase or decrease in the turnover.

(d) Investigate the causes of any material change in the rate of gross profit.

(e) Enquire into extraordinary expenses, e.g., donations paid to charities or item of a non-recurring nature, like expenses of foreign tours, those on an advertisement campaign and others which have resulted in changes of material amount on the revenue of the period.

(f) Ascertain whether there have been any changes in the basis of accounting which have resulted in significant increase or decrease in the amount of expenses included in the Trading and Profit and Loss Account e.g. due to non-provisions of closing stock of stationery or advertisement material, non-provisions of bonus or gratuity payment to staff, etc.

(g) Compare schedules of outstanding expenses and provision with those for the previous period and ascertain causes of any material changes therein; check in detail the provisions for depreciation and taxation.

Income Account :

(a) Verify different types of income in respect of which separate Demand Registers are maintained, by reference to them and confirm that amounts outstanding have been properly adjusted.

(b) Examine the system of invoicing goods to ensure that goods cannot be issued without the sale price thereof being received or the amount being debited to the customer's account.

(c) Reconcile the quantity of raw material consumed with quantities of finished products manufactured and compare the rate of wastage with that in the earlier period.

(d) Compare the total of each income account comprised in the Trading and Profit and Loss Account with the corresponding amount in the same account in the previous year and, if there is any material variation, find out reasons therefor.

Creditors :

(a) The creditors' ledger trial balance should be extracted by the client and agreed with the Control Account, if any, before the balances for confirmation are selected.

(b) The outstanding liability in respect of goods received, within the last week of the close of the year, should be verified by comparing entries in the Goods Inward Register with those in the Purchase Journal. In verifying this, due attention should be paid to the cut-off arrangement made by the client.

(c) A certificate should be obtained from the client that all the liabilities which had accrued upto the date of the Balance Sheet have been taken into account.

Debtors :

(a) The trial balance of the debtors' ledger should be extracted by the client and agreed with the Control Account, if any, before the balances for confirmation are selected.

(b) The amount of sales made during the week before the close of the year should be verified on comparing the entries in the Goods Outward Register with those in the Sales Journal. Here also, due attention should be paid to the cut-off arrangement.

(c) A certificate should be obtained from the client that all the book debts are good and recoverable and that a provision has been made against those considered bad or doubtful.

5.17 ANALYTICAL PROCEDURES

Nature and Purpose: Since routine checks cannot be depended upon to disclose all the mistakes or manipulation that may exist in accounts, certain other procedures also have to be applied. These collectively are known as overall tests. As stated earlier, with the passage of tests, analytical procedures have acquired lot of significance as substantive audit procedure. SA-520 on Analytical Procedures discusses the application of analytical procedures during an audit. "Analytical procedures" means the analysis of significant ratios and trends, including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:

- Comparable information for prior periods.
- Anticipated results of the entity, such as budgets or forecasts.
- Predictive estimates prepared by the auditor, such as an estimation of depreciation charge for the year.
- Similar industry information, such as a comparison of the entity's ratio of sales to trade debtors with industry averages, or with other entities of comparable size in the same industry.

Analytical procedures also include consideration of relationships:

- Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Various methods may be used in performing the above procedures. These range from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures may be applied to consolidated financial statements, financial statements of components (such as subsidiaries, divisions or segments) and individual elements of financial information. The auditor's choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures are used for the following purposes:

(a) to assist the auditor in planning the nature, timing and extent of other audit procedures;

(b) as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions; and

(c) as an overall review of the financial statements in the final review stage of the audit.

For instance, establishing the relationship that exists between certain balances included in the Balance Sheet and the Profit and Loss Account and comparing them with those that existed between the same set of balances in the previous years reconciling the physical balances of assets with the relevant financial record; obtaining of account from the bankers, customers and creditors and reconciling with relevant balances in books of account; confirming amounts of outstanding income and expenses by preparing reconciliation statements, etc. These are helpful in the detection of unusual state of affairs and mistakes in accounts. For example if on comparison of the gross profit ratio with that of the previous year, it is discovered that there has been fall in the ratio, it would be necessary for the auditor to make further enquiries. These may reveal that this was the result of pilferage of stocks, misappropriation of a part of the sale proceeds or a change in the cost of sales without a corresponding increase in the sales price.

Likewise, on verifying the balances of sundry debtors and creditors by obtaining the confirmation of their statements of account, it will be possible for the auditor to find out whether the discrepancy in the balance of a debtor is due to the failure to debit his account with the cost of goods supplied to him or is the result of non-adjustment of a remittance received from him. Also whether in the case of a creditor, the discrepancy is due to failure to afford him credit for one or more consignments of goods supplied by him or failure to debit him with an amount of remittance.

Similarly, by taking stocks of raw materials and stores at the end of the year any excesses or shortages therein shall be detected. The investigation of their causes might disclose that the shortages were the result of a misappropriation of stock or that the excess were due to requisitions having been entered before the stocks were issued.

Similarly, by reconciling the amounts of interest and dividends collected with the amounts which had accrued due and that which are outstanding for payment, the mistake, if any, in the adjustment of such an income would be detected.

The overall tests can be extended for making a inter-firm and intra-firm comparison of trading results. For example, if balances included in the trading account of an entity are compared with those contained in the trading account for the same period of another entity engaged in the same trade and working under similar circumstances, it would be possible to find out the cause of the variation in the rate of profitability that exists.

Similarly, it would also be possible to compare the balances on the trading account with that of the previous period, it would be possible to find out the reasons for increase or decrease in the amount of profits of those years. By setting up certain expenses ratios on the basis of balances included in the trading account, for the year under audit, comparing them with the same ratios for the previous year, it is possible to ascertain the extent of increase or decrease in various items of expenditure in relation to sales and that of gross profit in relation to sales. If differences are found to be material, the auditor would ascertain the reasons thereof and assess whether the accounts have been manipulated to inflate or suppress profits.

An abnormal fall in the cost of manufacture or that in the administrative cost, apart from economy in expenses, there could be no provision or less provision for expenses incurred in the year. When it is suspected, the auditor should compare the entries in the outstanding book with those in the previous year. He must also check the vouchers for one month immediately before the close of the following years. To verify that none of the expenses in the accounts under audit have been charged to the accounts of the following years.

Often it is possible to independently verify the correctness of some of the items of expenses included in the trading account. For instance the cost of importing goods which are subjected to an ad valorem duty at uniform rate can be verified from the amount of duty paid. Similarly, a quantity of sugar a mill sold can be verified independently from the amount of excise duty paid. Similarly, the amount of any income or expenses which has a direct relationship with the amount of profits or that of sales can be verified independently, *e.g.,* commission paid to a manager calculated on the basis of net profits, commission paid to a selling agent as percentage of sales, etc. Such calculation of ratios, trends and comparisons is also termed as analytical review.

Analytical Procedures in Planning the Audit: The auditor should apply analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk. Application of analytical procedures may indicate aspects of the business of which the auditor was unaware and will assist in determining the nature, timing and extent of other audit procedures.

Analytical procedures in planning the audit use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

Analytical Procedures in the Overall Review at the End of the Audit: The auditor should apply analytical procedures at or near the end of the audit when forming an overall

conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business. The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, in some cases, as a result of application of analytical procedures, the auditor may identify areas where further procedures need to be applied before the auditor can form an overall conclusion about the financial statements.

Extent of Reliance on Analytical Procedures: The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

(a) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(b) other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;

(c) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising; and

(d) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

Investigating Unusual Items: When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

(a) corroboration of management's responses, for example, by comparing them with the auditor's knowledge of the business and other evidence obtained during the course of the audit; and

(b) consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

5.18 DIRECT CONFIRMATION OF BALANCES

If the trial balance of the General Ledger agrees to the inclusion of the balance in the total accounts governing the Bought Ledger and the Sales Ledger (instead of individual balances of accounts contained therein), it would not necessarily prove that the balances in the account of the Bought and Sales Ledgers are correct. For there could still be compensating errors in the ledgers which would not affect the agreement of the trial balance. Therefore, it is essential that the individual balances of debtors and creditors should be verified on obtaining either confirmation of balance from them or detailed statements of account. SA 505, “External Confirmations”, lays down standards for external confirmation of balances. As per the Standard, the auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and

how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. The auditor should employ external confirmation procedures in consultation with the management.

Auditing and Assurance Standard SA 500, "Audit Evidence" states that the reliability of audit evidence is influenced by its source and nature. It indicates that, in general, audit evidence from external sources is more reliable than audit evidence generated internally, and that written (documentary) audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation requests received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related financial statement assertions to an acceptably low level.

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations, the auditor considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

The process of external confirmations, ordinarily, consists of the following:

- Selecting the items for which confirmations are needed.
- Designing the form of the confirmation request.
- Communicating the confirmation request to the appropriate third party.
- Obtaining response from the third party.
- Evaluating the information or absence thereof.

External confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so, the relevant details thereof. Other examples of situations where external confirmations may be used include the following:

- Bank balances and other information from bankers.
- Accounts receivable balances.

- Stocks held by third parties.
- Property title deeds held by third parties.
- Investments purchased but delivery not taken.
- Loans from lenders.
- Accounts payable balances.
- Long outstanding share application money.

The reliability of the evidence obtained by external confirmations depends, among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures. Factors affecting the reliability of confirmations include the control which the auditor exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

The following procedures should be followed for confirmation of the balances of debtors and creditors at the close of the year:

(a) Confirmatory letters, in respect of the balance, either as at the date of the Balance Sheet or as at another selected date before the close of the year, should be sent out within a period of 15 to 21 days after the end of the year even when the audit is taken up much later.

(b) If the number of accounts is large, letters may be issued only in respect of balances in the accounts of principal debtors and creditors, selected according to some system, which would ensure that the accounts selected would constitute a representative sample of all accounts of debtors and creditors. After the size and the contents of the sample have been determined, the client should be requested to prepare confirmatory letters requesting the parties to confirm the balances in their accounts as on a specified date.

(c) The balances shown in the confirmatory letters should be compared by auditors with the book balances of the debtors and creditors before the letters are despatched. He should also take control of the copies of these balances to prevent these being erased subsequently. The letters should be posted by the auditor. In case these are being posted by the client, there should be adequate check by the auditor that all the letters prepared have been duly posted.

(d) Each confirmatory letter should show the balance in the account of the debtor or creditor and the address of the auditors at which the confirmation under the signature of the party is to be sent. It should be signed by the client or the auditor, as has been mutually

agreed upon. Also a stamped envelope containing the auditor's name and address should be enclosed. The envelope containing the letter of confirmation should have the address of the auditor as the sendor.

(e) The debtors or creditors who fail to reply within a reasonable time should be reminded. Also, letters received back undelivered should be sent again at the correct address.

(f) On the confirmations being received, the auditor should verify that in each case either the balance has been confirmed or it can be satisfactorily reconciled. In case the balance in the account differs from that confirmed by the party, the client should be requested to prepare a reconciliation statement.

(g) In every case, where a reconciliation statement has been prepared, it should be verified that the difference in the amount confirmed and that shown by the books of account is not the result of an omission to credit any amount received from the party or failure to debit him with any amount of sales or to credit him with the value of goods received with a view to suppressing or inflating profits.

(h) If the difference is the result of some dispute or claim for an allowance or return, etc. not granted to the party, it should be confirmed that a provision equal to the difference which ultimately have to be credited to the party has duly been made.

Selection of accounts for direct verification : A few suggestions as regards selection of accounts for obtaining direct confirmation from parties are given below:

(a) *Credit Balances* : Balance in the accounts of suppliers, depositors, employees, securities deposited by creditors.

(b) *Sundry debtor balances* : Balances of advances to suppliers, balances recoverable for goods sold, securities deposited, etc. especially when the balances are in round figures have been continually increasing. It is usually not possible to obtain confirmation of amounts outstanding against Government Departments. These, thus, should be left out.

(c) (i) A certain percentage of total number of accounts should be selected: some on the basis of largeness of their balances and others according to numerical or alphabetical order. For example, all accounts having balances above Rs. 10,000 may be included in the list of balances prepared for obtaining confirmations. Also accounts of parties with names beginning with, say "B" and "M" may be included in the list.

(ii) A few amount with no unpaid items, as well as those the balance whereof have been written off during the period under review should be specially included. Furthermore, accounts wherein payments or other credits have been adjusted subsequent to the confirmation date should not be omitted.

(iii) Accounts of parties, any cheque whereof has been received back unselected and accounts which are 'dead', *i.e.,* wherein there has been no operation during the year should also be included.

The group of accounts selected in the foregoing manner for obtaining confirmation of the debtor's and creditors' balances would be representative sample of all the accounts of debtors and creditors.

Unless there is evidence that the difference in the amounts confirmed and those shown by the respective accounts in the books is the result of some omission of fictitious entries, the position as revealed by direct verification of a sample of accounts could be accepted.

Self-examination Questions

1. Examine whether you consider the following to be sound, giving reasons :
   (i) For materials purchased, Materials Inspector has to inspect the materials received and pass it before the stock section can accept them. The form of inspection note provides the space on purchase order having no challan reference, party's name and particulars of materials. The Materials Inspector has to write, on the given space, whether the materials conform to the technical standard required by the organisation.
   (ii) The cashier of a company has control over all the financial books; in addition, he is authorised to open all letters and acknowledge receipt of letters and cheques.
   (iii) With a view to ensuring proper co-ordination, the purchase officer has been given the additional task of store supervisor.
   (iv) There is system of encashing the casual leave and earned leave in an organisation. The employees generally do not avail of the leave for this additional cash benefit. The management is happy that due to negligible incidence of absence, work in the office moves smoothly and there is no necessity of employing additional hands.
   (v) The investments held by a company are kept under the personal custody of the Chief Accountant.
   (vi) A company having about 2500 debtors has introduced self-balancing ledger system.
   (vii) The scrap and waste of the mill are under the charge of the mill manager.
2. How would you vouch the following classes of payments :
   (a) Travelling Expenses;
   (b) Customs and Excise Duties;
   (c) Payments under a hire purchase contract;
   (d) Under leasing transaction;

(e) Penalty assessed for an authorised import of a machine part; and

(f) Directors' fees ?

3. How would you verify undermentioned receipts :

(a) Sale proceeds of junk material;

(b) Dividend on investment in shares of companies, and interest on 4% Karnataka State Loan;

(c) Membership subscription of a Cricket Club;

(d) Advertisement revenue; and

(e) Refund of taxes paid ?

4. (a) During the course of an audit, you find that some payment vouchers are missing. What will be your duty in such a case ?

(b) Discuss the importance of checking totals of books of account and state how by mis-totalling a ledger or cash book, a fraud may be committed.

(c) Explain how a fraud is perpetrated by the Teeming and Lading method.

5. State the evidence that you would require in vouching following;

(i) Sales of scrap Rs. 10,000

(ii) Travelling expenses Rs. 6,000

(iii) Directors' fee Rs. 3,000

(iv) Purchases Rs. 24,500

6. How would you verify the following items of income appearing in the accounts of a company :

(a) Sales commission;

(b) Underwriting commission;

(c) Dividend received from Official Receiver in respect of Rs. 1,000 due from Mr. K. the amount whereof was written off by the company several years ago; and

(d) Rents of properties ?

7. During the audit for the year 1994-95 you notice that journal entries have been passed to allow rebates in respect of sales that had taken place in 1993-94 and 1992-93; also entries have been passed to cancel some of the sales entries in the previous year's accounts. Indicate the line of enquiry that you will be making to satisfy yourself about entries made.

8. State the points that you would bear in mind while vouching income and expense accounts.

9. What do you understand by "Accounting Principles" ? Explain with illustration how the true and fair view of the accounts would be impaired if the accounting principles are not followed.
10. What are the different possibilities if no cut-off arrangement is made by the client?
11. What principal points would receive your attention as an auditor for the verification of goods on consignment in : (*a*) the Consignor's Books; and (*b*) the Consignee's Books ?
12. The proprietor of a manufacturing business asks you to investigate the reasons for an unusual fall in the trading profits inspite of the turnover being at par with the last year. Enumerate the possible reasons for such a fall and indicate the lines on which you would proceed to conduct the investigation.
13. Your client in 1992 had made a provision of Rs. 5,000 for the payment of a claim on account of enhancement in the price of goods supplied to him. While auditing the amount for the year 1998 you find that the claim during this year has been settled for Rs. 8,000 and the amount has been debited to the Purchases Account of the year. What is your duty in this regard ?
14. By resorting to overall checks, the truth and fairness of statements of accounts can be ascertained. Suggest the overall checks on the following:
    (i) Wages.
    (ii) Plant and machinery.
    (iii) Stock.
    (iv) Sales Commission.
15. State the importance of audit of revenue accounts in the total audit objective.
16. Outline the internal check that should exist on making posting ledgers. Explain its importance and illustrate your answer by reference to frauds which its absence might give rise to.
17. While auditing the accounts of a trading concern, how would you verify that all liabilities incurred before the close of the year in respect of wages, freight and traveller's commission have been included in the accounts ?
18. You are provided by your client with a schedule of debtors balances at the close of the year. How would you proceed to verify these balances before including them in the final account?
19. Before finalising the audit of accounts of a sugar mill, you find that the labour union has claimed 2 months bonus and the matter is before the Reconciliation Officer. The management is willing to pay one month's bonus but not two. How would you show the existence of such a liability to the shareholders ?

20. If the trial balance of a concern tallies on including the balance of total accounts of subsidiary ledgers, would you be satisfied as regards the accuracy of the individual balances contained ? Give reason for your answer.
21. While auditing the accounts of a large concern having five Debtor's Ledgers and two Suppliers' Ledgers, kept on the self-balancing principle, would it be necessary for you to check in detail in the posting into subsidiary ledgers ? Give reasons for your answer.
22. You find the provision for some 50 separate items of liabilities made in the previous year aggregating Rs. 50,000 written back at the commencement of the year by credit to appropriate accounts. Would you consider such a practice to be regular ?
23. Discuss general considerations involved in the examination of Debtors' and Suppliers' Ledger :
24. State what information you would require and what documentary evidence you would see while vouching the following:—
    (a) Preliminary Expenses
    (b) Freight, Carriage and Custom Duty
    (c) Director's Remuneration
    (d) Travelling Expenses.
25. How will you vouch the following items of income recorded in the accounts of a company:—
    (i) Interest from parties for loans given;
    (ii) Rents;
    (iii) Royalties;
    (iv) Insurance claims.
26. When examining the sales ledger records of a cloth wholesaler you discover that there has been a marked increase, as compared with the previous year, in the volume of credit notes issued to customers and in discounts allowed to them. Tabulate the possible courses of these increases and state the steps you would take, as auditor, to investigate each possible cause.
27. (a) As an auditor of a large manufacturing organisation you observe that a substantial amount of capital expenditure is incurred from its store and own labour. He would you proceed with regard to the audit of the above.
    (b) Write short notes on the vouching of the following payments :—
        (i) Travelling expenses for foreign tour.
        (ii) Outward freight.

28. What are the special steps to be taken by the auditor in vouching the following transactions?
    (a) Sales made during the last few days of the year
    (b) Goods sent to dealers free of charge by way of quantitative discount.
29. (a) How do you vouch the following payments:
        (i) Wages paid to Seasonal Labourers
        (ii) Clearing and Forwarding Charges
    (b) While carrying out vouching of transactions of a large manufacturing concern you notice three deviations from regular internal procedure of the client followed in past years. Firstly, in a large number of cases payment vouchers are not passed by department heads. Also purchases are being made from suppliers who are not pre-approved. Apart from these, payments other than petty payments are being made by cash instead of by account payee cheques. What precautions as an auditor will you take in view of the above.
30. How will you deal with the following as an auditor ?
    (a) Bonus to employees which was hitherto being charged to Profit & Loss Account on mercantile basis is not being accounted for on cash basis.
    (b) There is significant fall in market price of some investments held for a long time by the concern.
    (c) Outstanding liabilities for expenses show a considerable fall as compared to last year.
31. (a) M/s. Ajay Stores is having a number of debtors arising on credit sales to customers. What procedures would you suggest to ascertain the correctness of debtors remaining outstanding at the close of the year?
    (b) What records should be maintained and care taken when goods are sold on approval basis?

Multiple Choice Questions

1. Which of the following documents is not relevant for vouching cash sales --
    (a) Daily cash sales summary
    (b) Salesmen's summary
    (c) Monthly statements sent to customers
    (d) Bank statement

2. The auditor should examine subsequent realisation of revenue such as dividends, interest, commission, etc to --

   (a) Identify cases of unrecorded revenue

   (b) Ensure proper disclosure in the balance sheet

   (c) recomputed accrued income on the date of balance sheet

   (d) Any of these

3. To test whether sales have been recorded , the auditor should draw a sample from a file of --

   (a) Purchase orders

   (b) Sales Orders

   (c) Sales Invoices

   (d) Bill of lading

4. For vouching of which item, the auditor is most likely to examine cost records?

   (a) Commission earned

   (b) Bad debts recorded

   (c) Credit Sales

   (d) Sale of scrap

5. The "Guidance Note on Revenue" issued by the ICAI does not deal with --

   (a) Sales revenue

   (b) Revenue from rendering services

   (c) Revenue from sale of fixed assets

   (d) Income from interest, dividends, etc.

6. An auditor conducts a surprise check on the pay day (i.e. the day wages and salaries are paid). The primary purpose of this audit procedures is --

   (a) To assure that there are no ghost workers

   (b) To assure the casual workers employed are authorised by the supervisor

(c) To test procedures for distributing pay cheques

(d) to obtain understanding of internal control System

7. Which of the following would prevent double payment of the same voucher ?

(a) The person signing the cheque should cancel the supporting documents.

(b) Cheques should be signed by at test two persons

(c) The date of payment of vouchers of similar nature should be the same of close to each other.

(d) All of the above.

8. An internal audit of wages and salaries showed that on several occasions, a clerk handling the same , had added those casual workers to the wage sheet. What controls would have prevented this ?

(a) Examine the sanction of competent authority

(b) Examine terms of employment

(c) Pay surprise visits on sites

(d) All of the above.

9. In case of unclaimed wages, the auditor should examine whether –

(a) The amount has been deposited in a separate ban account

(b) Deposited with the cashier

(c) Held in a safe deposit box

(d) All of These

10. While vouching wages, auditor should examine whether there is proper segregation of duties. Which of the following activates should not be done by same department ?

(a) Maintaining personnel records and approving changes in wage rates

(b) Proposing pay roll summary and disbursement of wages

(c) Making salary statements and filing tax returns

(d) Comparing time clock records with time reports prepared by supervisors and preparing list of workers employed along with the units of production for each one of them

11. In order to vouch, which of the expenses , the auditor will examine bill of entry ?

(a) Custom duties

(b) Excise duties

(c) Sales tax

(d) Income tax

12. Which vouching, how will the auditor ensure himself that all credit sales transactions have been recorded by the entity ?

(a) Examining cut-off points

(b) Matching entries in the sales book against renumbered sales invoices and goods outward notes

(c) Counting the number of invoices and matching the number with entries on sales boo

(d) Both (a) And (b)

13. In Case of sales return, the auditor should examine which documents ?

(a) Credit notes, advice notes and inward return notes

(b) Debit notes, advice notes and inward return notes

(c) Purchase invoices, advice notes and inward return notes

(d) Credit notes, inspection report and inward return notes

14. An internal auditor discovered that fictitious purchases have been recorded by the purchase clerk. This indicates absence of which control ?

(a) Purchase invoices are independently matched with purchase orders and goods received notes

(b) Goods received notes require the signature of the individual who authorised the purchase

(c) Routine checks are performed by internal auditor fortnightly.

(d) Purchase function and production function are clubbed in one department

15. Which of the following is most crucial to a purchase department ?

(a) Reducing the cost of acquisition

(b) Selecting supplies

(c) Authorising the acquisition of goods

(d) Assuring the quality of goods

16. The auditor is most likely to examine related party transactions very carefully while vouching –

(a) Credit sales

(b) Sales returns

(c) credit purchases

(d) cash purchases

17. In order to vouch bought ledger, the auditor obtain confirmations from creditors. The principal reason for the auditor to examine suppliers statements at balance sheet date is to obtain evidence that --

(a) The supplier exist

(b) There are no unrecorded liabilities

(c) Recorded purchases actually occurred

(d) To link creditors with cash book entries.

17. The creditors accounts, generally, have credit balances. Debit balance may be due to –

(a) Advance paid against an order

(b) Goods returned

(c) Wrong debit to supplier account

(d) any of the above

19. In case of vouching, the auditor is least likely to examine authorisation by appropriate authority in case of --

    (a) Bad written off

    (b) Sales return

    (c) Purchase return

    (d) discount allowed to customers as per organisational policy

20. Vendors should be approved by Management before purchase department executes an order. If this is not done, then which of the following situations may arise --

    (a) Purchases could be made from vendors whose product quality may not be good

    (b) Purchases may be made from related parties without management's knowledge

    (c) Purchases could be made from vendors who may have offered prices to vice-president purchases

    (d) Any of the above

CHAPTER 6

VERIFICATION OF ASSETS AND LIABILITIES

Learning Objectives

After studying this chapter, you will be able to -

- Make a clear distinction between revenue and capital expenditure
- Understand provision for providing depreciation and reserves has been dealt in detail.
- Verify various kinds of assets and liabilities.
- Identify events occurring after the balance sheet date.

6.1 CAPITAL AND REVENUE EXPENDITURE

6.1.1 Capital Expenditure

A capital expenditure is that which is incurred for the undermentioned purposes:

(a) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.

(b) Making additions to the existing fixed assets.

(c) Increasing earning capacity of the business.

(d) Reducing the cost of production.

(e) Acquiring a benefit of enduring nature of a valuable right.

The different forms that capital expenditure takes are: (*i*) land; (*ii*) building; (*iii*) plant and machinery; (*iv*) electric installations; (*v*) premium paid for the lease of a building; (*vi*) development expenditure on land; and (*vii*) goodwill; etc.

Expenses which are essentially of a revenue nature, if incurred for creating an assets or adding to its value or achieving higher productivity, are also regarded as expenditure of a capital nature.

Examples :(i) Material and wages-capital expenditure when expended on the construction of a building or erection of machinery.

(ii) Legal expenses- capital expenditure when incurred in connection with the purchase of land or building.

(iii) Freight- capital expenditure when incurred in respect of purchase of plant and machinery.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

6.1.2 Revenue Expenditure

An expenditure, the benefits of which is immediately say within one year expended or exhausted in the process of earning revenue., eg., on purchase of goods for sale, on their movement from one place to another, on maintaining assets, on keeping a business organization going, etc. is a revenue expenditure. Examples of revenue expenditure are:

(i) Cost of raw material and stores consumed in the process of manufacture.

(ii) Salaries and wages of employees engaged directly or in-directly in production.

(iii) Repairs and renewals of fixed assets.

(iv) Advertisements

(v) Postage

(vi) Printing and Stationery

(vii) Rent, rates and taxes

(viii) Insurance

(ix) Interest on borrowings, etc.

6.2 DEPRECIATION

6.2.1 Definition of Depreciation

Accounting Standard 6 issued by the Institute of Chartered Accountants of India on "Depreciation Accounting" defines depreciation as follows:

"Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, obsolescence through technology

and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose usefulness is predetermined".

The term "depreciable amount" of a depreciable asset as per the standard is its historical cost, or other amount substituted for historical cost in the financial statements less the estimated residual value.

The accounting standard recommends that the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

6.2.2 Purposes of Providing Depreciation

(a) *To keep capital intact* : It will be evident that one of the effects of providing for depreciation on an asset is to retain in the business out of the profits in each year, an amount equal to the proportion of the cost of the asset employed in the business that has run off, estimated on the basis of the period of its working life and its scrap value. Thus, the original capital of the entity, assuming that all profits have been withdrawn and losses, if any, made good, will be intact. If, on the contrary, depreciation had not been charged, the net income would have been overstated over the years of the life of the asset, and if the same was withdrawn or distributed as dividends, the business would have no funds for the replacement of the asset.

(b) *To ascertain cost accurately* : Unless a proper charge on account of depreciation is included in the Profit and Loss Account, the true cost of manufacture of different products will not be ascertained. This is because depreciation is as much a charge against revenue as any other expenditure and must be included in accounts irrespective of the fact whether the final result of a working is profit or loss.

(c) *To charge initial costs against earnings* : The cost of a machine less its scrap value can, in effect, be regarded as the price for use of the machine paid in advance for the period it will be rendering service. According to this view unless an appropriate part of this price is charged to the profits of the business each year, the profit earned on its working will not be correctly ascertained.

The object of depreciation accounting thus is to determine on a scientific basis, the proportion of the cost of a machine which must be charged in the accounts of each year during which the machine will be used. Depreciation is an expense incurred for earning profit, which is similar to the hire of an asset, the only difference being that in one case the amount is paid to an outsider while, in the other, it is kept in the entity itself. Therefore, each accounting period must be charged a fair proportion of the cost of fixed

assets as the price for their use, and the charge should not be contingent on profits being earned. Accordingly, depreciation is a charge against profits and not an appropriation out of profits.

(d) *To prepare true and fair statements* : Unless depreciation is provided, the assets will be shown at an amount higher than their true value and the profit shown will be more than the real profit. In other words, the Balance Sheet and the Profit and Loss Account will not be true and fair.

Depreciation should not be confused with any fluctuation in the value of fixed assets. The market price of an asset at the end of a year may be either more or less than its book value. It would be the result of a rise or a fall in the price level, a factor over which the business has no control. Such fluctuation in the value of assets may or may not be taken into account, for fixing the sale price of the articles manufactured, but these must be totally ignored for computing the amount of depreciation chargeable to the Profit and Loss Account.

6.2.3 Depreciation on Wasting Assets

In terms of the decision in the case *Lee* v. *Neuchatel Asphalte Co. Ltd. (1889)*, there does not appear any necessity to provide depreciation on wasting assets like mines, quarries, etc. In the present-day context, however, it is highly doubtful whether the principle propounded in the above case would hold good. Wasting assets exhaust by working and necessarily that involves depletion of the capital employed on such assets. It is, therefore, necessary with a view to maintain the capital employed, a charge for such depletion for ascertaining a true and fair view of the accounts. By this process, the cost inherent in depletion would be accounted for and the fair value of the asset would be disclosed in the Balance Sheet. The term depletion stands for depreciation in case of a wasting asset, because here depreciation is really represented by the quantum of diminution of the deposits of materials in the wasting asset.

The legal position governing depreciation in case of a company is contained in the Companies Act, 1956. However, it is enough to know at this stage that in the opinion of the Company Law Board (Now National Company Law Tribunal), depreciation on wasting assets is a necessary charge for arriving at the true and fair picture of the Profit and Loss Account and Balance Sheet.

6.2.4 Methods of Depreciation

There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straightline method and the reducing balance method.

Under the Straight Line Method, an equal amount is written off each year during the life of the asset. *Under the Reducing Balance Method*, the annual charge for depreciation decreases from year to year with the result that earlier years suffer to the benefit of later years. Also under this method, the value of an asset can never be completely written off. The rate of depreciation to be applied in the case of the Reducing Balance Method is substantially higher than that which must be applied under the Straight Line Method if an asset is to be written off within a certain period. For example, if an asset to the written off to 5% of its original cost over 13 years, under the Straight Line Method the rate of depreciation will be 7.3% but the equivalent rate under Reducing Balance Method will be 20%.

The main advantage of the Reducing Balance Method is that during the first few years, when the charge on account of depreciation is heavier, the cost of repairs is usually small and thus, the total charge for each asset is distributed almost equal annually throughout its life, taking cost of repairs also into account. What is claimed as an advantage for the Reducing Balance Method is a drawback in the case of the Straight Line Method. This can be overcome by building up a reserve for repairs and renewals. This is done by an equal amount determined on estimating the average cost of repairs and renewals being annually charged to the Profit and Loss Account and credited to the provision for repairs account. Against this provision for the expenditure on repairs and renewals is charged as and when incurred, with the result that the annual charge for depreciation and repairs is equalised.

The various important factors which the management should take into account while selecting a particular method are:

(i) type of asset;

(ii) the nature of the use of the asset;

(iii) circumstances prevailing in the business; and

(iv) state of the economy-whether stable or inflationary.

For example, in a stable economic condition, a going concern with steady operations may select the straight line method. Further certain assets like patents and trade marks should also be depreciated on a straight line basis because of their nature conditioned by a

legally prescribed life. A company with uneven asset acquisition over the years may go for written down value method.

The method of depreciation is applied consistently to provide comparability of the results of the operation of the enterprises from period to period. A change from one method of providing depreciation to another is made only if adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statement of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the assets coming into use. The deficiency or surplus arising from recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of the past years, the deficiency is charged in the statement of Profit & Loss. In case the change in method results in surplus, the surplus is credited to the Profit & Loss Account in the year in which such change is made. Such a change in method is a change in the accounting policy and its effect is quantified and disclosed.

6.2.5 Determining the Amount of Depreciation

The assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors :

(i) historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;

(ii) expected useful life of the depreciable asset; and

(iii) estimated residual value of the depreciable asset.

The useful life of a depreciable asset is shorter than its physical life and is:

(i) pre-determined by legal or contractual limits, such as the expiry dates of related leases;

(ii) directly governed by extraction or consumption;

(iii) dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise, etc; and

(*iv*) reduced by obsolescence arising from such factors as :

(a) technological changes;

(b) improvement in production methods;

(c) change in market demand for the product or service output of the asset; or

(d) legal or other restrictions.

Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

The useful lives of major depreciable assets or class of depreciable assets may be reviewed periodically. Where there is revision of estimated useful life of an asset, the unamortised depreciation amount should be charged over the remaining useful life too.

An entity may adopt different types of methods of depreciation for different types of assets provided the same are adopted on a consistent basis. Even a company having plants at different locations may adopt different method of depreciation in the same accounting year. Further, it may be noted that the depreciation would be charged on pro-rata basis in respect of assets acquired during the financial year.

6.2.6 Depreciation on Low Value Items

The Department of Company Affairs (Now Ministry of Company Affairs), Government of India, issued a notification during December 1993, which has inserted as Note No. 8 in Schedule XIV to the Companies Act, 1956. Notwithstanding anything mentioned in Sched-

ule, depreciation on assets, whose actual costs does not exceed Rs. 5,000 shall be provided @ 100%. According to the above note, the individual items of fixed assets whose actual cost does not exceed Rs. 5,000, shall be charged depreciation @ 100%. However, in respect of the fixed assets acquired prior to December, 1993 alternative basis of computing the depreciation charge are permitted. However, if individual item of plant and machinery costing Rs.5000 or less constitutes more than 10 percent of the total actual cost of plant and machinery, than in that case depreciation should not be provided at 100% of actual cost of such asset. The rates of depreciation applicable to such items shall be the rate as specified in Schedule XIV.

It is to be noted that Note 4 to Schedule XIV requires *inter alia* where during any financial year any addition has been made to any assets, the depreciation on such assets should be calculated on a pro rata basis from the date of such addition. Since Note 8 to Schedule XIV prescribed the rate of depreciation of 100%, pro rata depreciation should be charged on addition of the said low value items of fixed assets also. However, the company can write off fully low value items on the consideration of materiality. Where such an accounting policy is followed by a company, the same should be properly disclosed in the accounts.

6.2.7 Disclosure in the Profit and Loss Account and Balance Sheet of a Company

Clause 3(*iv*) of Part II to Schedule VI to Companies Act, 1956 provides that the Profit and Loss Account must disclose the amount of depreciation, renewals or diminution in value of the fixed assets. If such a provision is not made by means of a depreciation charge, the method adopted for making such a provision should be disclosed. If no provision has been made for depreciation in respect of a particular asset, the fact that no provision has been made should be stated and the quantum of arrears of depreciation computed in accordance with Section 205(2) should be disclosed by way of a note.

The form of the Balance Sheet prescribed under the Part I of Schedule VI to Companies Act, 1956, further requires that total depreciation written off or provided in respect of each asset should be disclosed.

Accounting Standard 6 requires following information to be disclosed in the financial statements;

(i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;

(ii) total depreciation for the period for each class of assets; and

(iii) the related accumulated depreciation.

It also requires following disclosure of information in the financial statements alongwith the disclosure of other accounting policies;

(i) depreciation method used; and

(ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

6.2.8 Legal Necessity of Provision for Depreciation

On account of the provision under section 205 that, no dividend shall be declared except out of profits arrived at after providing for depreciation in accordance with the provisions of the Act, it has become obligatory for every company distributing dividend to make a provision for depreciation.

Sub-section (2) of Section 205 prescribes different methods that may be adopted for computing the amount of depreciation. There are summarised below:

(1) The charge on account of depreciation may be calculated in the manner required by Section 350. As per the Companies (Amendment Act), 1988, the amount of depreciation was calculated with reference to the written-down value of the assets as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year, at the rate specified in schedule XIV. Thus, depreciation is now required to be calculated in accordance with the rates specified in the new Schedule XIV to the Act and thereby delinking in the Companies Act, 1956 from that under the Income Tax Act, 1961.

However the Companies (Amendment) Act, 2000 w.e.f. 13.12.2000 has amended section 350 and deleted the words, " the amount calculated with reference to the written down value of the assets" by the words, "the amount of depreciation assets". Therefore depreciation in future would be with reference to amount as per books of account and which may be on SLM basis.

(2) However, it may be noted that schedule XIV to the Companies Act, 1956 provides rates as per straight line method as well.

(3) The provision for depreciation may be made on any other basis approved by the Central Government which has the effect of writing off by way of depreciation 95% of the original cost to the company of each depreciable asset at the expiry of the specified period.

It is provided further that if an asset is sold, discarded, demolished or destroyed, for any reason before depreciation if such asset has been provided in full, the excess of its written value, if any, at the end of the financial year in which it is sold, discarded, etc. over its sale proceeds of scrap value, also must be written off in that year, in which the asset is sold, discarded, demolished or destroyed.

(4) If a company possesses a depreciable asset for which no rate of depreciation has been prescribed by the Companies Act, 1956 or the Rules framed thereunder, the amount of depreciation should be computed on such basis as the Central Government may approve, either by any general order published in the Official Gazette or any special order in a particular case.

6.2.9 Provision of Depreciation for Past Years

Section 205(1) prescribes that if a company has not provided for depreciation for any previous financial year it shall, before declaring, or paying dividend, provide for such depreciation :

(a) either out of the profits of that financial year, or

(b) out of the profits of any other previous financial year or years.

The implication of this rule is that if, for example, the profits of a company for the year ending 31st March, 1991 are proposed to be distributed, and it is found that due to inadequacy of profits no provision for depreciation had been made for the year ended 31st March, 1990 it would be necessary to make provisions in respect of the depreciation, for the year ended 31st March, 1990 as well as 1991 and only the balance of the profits for the year 31st March, 1991 would be available for distribution as a dividend.

There are, however, two exceptions to this rule :

(1) The profits of financial year or years ended before 28th December, 1960 may be distributed even though in arriving at these profits no depreciation in respect of past years had been provided.

(2) A company may be permitted by the Central Government, if it is thought necessary, to pay dividend for any financial year, without first providing for depreciation for that year or for any earlier year. The Central Government would, however, exempt a company only if it finds that such a distribution is necessary in the public interest [clause(*c*) of the first provision to sub-Section (I) of Section 205].

Ascertainment of depreciation for computing net profits for the purpose of managerial remuneration : Under Section 198(1) of the Companies Act, 1956 depreciation calculated

in the manner specified in Section 350 must be deducted for arriving at the amount of net profits, on which remuneration payable to managerial personnel is to be calculated.

6.2.10 Auditor's Duty as Regards Depreciation

Apart from fixed assets in respect of which depreciation must be provided in the manner aforementioned, it also has to be provided on semi-permanent assets, *e.g.*, patents, trade marks, blocks and dies, etc. Since the auditor is not in a position to estimate the working life of a majority of them, for this he has to rely on the opinion of persons who have a technical knowledge of the assets. He must, however satisfy himself that an honest attempt has been made to estimate the working life of each asset, that the total provision for depreciation is adequate and that the method adopted for determining that amount to be written off appears to be fair and reasonable. If he is of the opinion that the provision for depreciation is not adequate, he should report to the appropriate authority. He must also see that depreciation written off is properly disclosed in the Profit and Loss Account and the Balance Sheet.

In Part III of Schedule VI of the Act, it is provided that any amount, written off (after the commencement of the Act) which is in excess of the amount, which in the opinion of the directors is reasonably necessary for the purpose, to be regarded as a 'reserve'. The amount should be shown as a reserve under head "Reserve and Surplus" on the liabilities side of the Balance Sheet. If, however, it has been written off prior to the commencement of the Act, it is not to be treated as a reserve, and such excess depreciation in the case should be deducted along with the normal depreciation from the cost of the asset.

6.2.11 Revaluation of Fixed Assets

In recent years, due to an abnormal rise in the price level, it has been suggested in many quarters that accountants should modify the practice that so far prevailed of calculating the provision for depreciation on historical cost (*i.e.*, original cost of fixed assets) and may, for the purpose adopt the replacement cost basis. In support of such a view, it has been argued that, as a result of the rise in the price level, replacement costs of assets have gone up to such an extent that the depreciation provision, based on the original costs, does not leave in the business sufficient funds enabling it to replace its fixed assets. Thus when financial statements are prepared on a basis other than historical cost basis, it is necessary that depreciation should also be computed accordingly on the revised book value of the assets. The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by

restating the net book value by adding therein the net increase on account of revaluation. An upward revaluation does not provide a basis for crediting to the profit and loss statement the accumulated depreciation existing at the date of revaluation. Further an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve, it is sometimes charged against that earlier increase. It sometimes happens that an increase to be recorded is a reversal of a previous decrease arising on revaluation which has been charged to profit and loss statement in which case the increase is credited to profit and loss statement to the extent that it offsets the previously recorded decrease. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve. AS-6 on "Depreciation Accounting, requires where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. A question may arise, as to whether the additional depreciation required in consequence of revaluation can be adjusted against revaluation reserve or charge to profit and loss account. As per requirement of Part-II of Schedule-VI to the Companies Act, 1956 the company will have to provide the depreciation on the total book value of fixed assets (including the increased amount as a result of revaluation). However, for certain statutory purpose, e.g., dividends, managerial remuneration, etc., only depreciation relatable to the historical cost of the asset is to be provided out of the current profit of the company. After taking into consideration both these points, the guidance note on "Treatment of Reserve Created on Revaluation of Fixed Assets" provides that the company can charge the depreciation on the total book value of the fixed assets (including the increased amount as a result of revaluation) in the profit and loss account of the relevant period and thereafter the company can transfer an amount equivalent to the additional depreciation from the revaluation reserve. Such transfer from revaluation reserve should be shown in profit and loss account separately and a proper disclosure by way of notes to account.

6.2.12 Impairment of Assets

Beside charging annual depreciation on assets by the reason of normal wear and tear, afflux ion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the asset can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as Impairment Loss. The treatment of impairment loss is similar to depreciation except the fact that impairment loss can be re-instated in future if the recoverable amount of the asset exceeds the carrying amount. Various external and internal sources of information can be taken as the basis of determining the impairment for Assets.

The auditor must ensure that provisions of AS 28, "Impairment of Assets" issued by the Institute are followed.

6.3 RESERVES

6.3.1 Reserves v. Provision

Reserves are amounts appropriated out of profits which are not intended to meet any liability, contingency, commitment or diminution in the value of assets known to exist at the date of the Balance Sheet. In contradistinction, provisions are amounts charged against revenue to provide for:

(i) depreciation, renewal or diminution in the value of assets; or

(ii) a known liability, the amount whereof cannot be determined with substantial accuracy; or

(iii) a claim which is disputed.

Amounts contributed or transferred from profits to make good the diminution in assets values due to the fact that some of them have been lost or destroyed, as a result of some natural calamity or debts have proved to be irrecoverable are also described as provisions. Provisions are normally charged to the Profit and Loss Account before arriving at the amount of profit. Reserves are appropriations out of profits.

The difference between the two is that provisions are amounts set apart to meet specific liabilities of diminution in assets value. These must be provided for regardless of the fact whether or not any profit has been earned by the concern. If a provision is in excess of the amount considered necessary, the same must be written back or credited to a Reserve Account. On this consideration, in Part III of Schedule VI to the Companies Act, 1956,it is provided that a provision in excess of the amount which, in the opinion of the directors, is reasonably necessary for the purpose should be treated as a reserve.

Reserves are made up of amounts appropriated out of profits, held for equalising the dividends of the company from one period to another or for financing the expansion of the company or for generally strengthening the company financially.

If we examine the Balance Sheet of a company, at a given time, and deduct the total liabilities to outside creditors from the value of assets shown therein, the difference between the two figures will represent the net worth of the company based on the book values of assets as on that date. It will consist of the capital contributed by the shareholders as well as total undistributed profit held either to the credit of the Profit and Loss Account or to reserves; the reserves again will be segregated as revenue or capital reserves. It may be noted that the amount of a reserve is affected by the values placed on assets. If these are excessive, the real reserve might not exist at all or be smaller than the figure at which it is shown in the balance sheet.

Revenue reserves represent profits that are available for distribution to shareholders held for the time being or any one or more purpose, e.g., to supplement divisible profits in lean years, to finance an extension of business, to augment the working capital of the business or to generally strengthen the company's financial position.

A capital reserve on the other hand represents surplus or profit earned in respect of certain types of transactions; for example, on sale of fixed assets at a price in excess of cost, realisation of profits on issue of forfeited shares or balances which because of their origin or the purposes for which these are held, are not regarded by the directors as free for distribution as a dividend through the Profit and Loss Account. However, students may note that as per AS-5, profit or losses arising out of sale of fixed assets should be routed through profit and loss account though they may be shown separately.

According to the definition of capital reserve, contained in Part III of Schedule VI to the Companies Act, 1956 it is a reserve which does not include any amount regarded as free for distribution through the Profit and Loss Account. In its narrowest sense, therefore the description would include only share premium, capital redemption reserve, development rebate reserve and profit on reissue of forfeited shares. Capital profits representing surpluses realised on the sale of assets, profit on redemption of debentures and the like, in certain circumstances, are capable of being distributed as dividends. Thus, strictly, these do not form a part of capital reserves in all cases or at all time since circumstances may change from one year to another. It may further be noted that if a company appropriates revenue profit for being credited to the asset replacement reserve with the objective that these are to be used for a capital purpose, such a reserve also would be a capital reserve.

A capital reserve, generally, can be utilised for writing down fictitious assets or losses or (subject to provisions in the Articles) for issuing bonus shares if it is realised. But the amount of share premium or capital redemption reserve account can be utilised only for the purpose specified in Sections 78 and 80 respectively of the Companies Act, 1956.

Students may further note that according to the form prescribed for the Balance Sheet in Schedule VI, the amount of capital and revenue reserves must be shown separately. Also capital redemption reserve and share premium account must be segregated. Further, if there are more than one kind of revenue reserves, their nature and amounts must be disclosed; also the balance of the Profit and Loss Account, if in debit, should be deducted from the revenue reserve.

Clause (*viii*) of Part II of Schedule VI further provides that the aggregate of amount are set aside or proposed to be set aside to reserves, if material, should be disclosed in the Profit and Loss account. Similarly aggregate of amounts, if material, withdrawn from reserves should be disclosed.

Reserves either may be retained in the business as a part of the working capital or invested outside the business in marketable securities. To the extent additional capital can be usefully and profitably employed in the business, undistributed profits should be left in the business. For these when so employed, would earn a higher return than what they would if they were invested outside in the shares or debentures of another company. So much of the profits as cannot be usefully employed in the business as well as the part of the profits earned which necessarily must be invested outside the business, under some legal obligation *i.e.*, for the redemption of debentures, reserves should be invested in such securities which are easily realisable and the prices whereof are not liable to wide fluctuations. The term 'Reserves Fund' should be employed to describe a reserve only when the amount of reserve is invested outside the business and it is represented by the readily realised assets.

Reserves which are not disclosed in the Balance Sheet are known as secret or hidden reserves. Secret reserves can be created in the following ways :

(i) By writing down fixed asset more than what is necessary.

(ii) By writing off capital expenditure as though it were revenue.

(iii) Under-valuation of stock-in-trade.

(iv) By making an excessive provision for bad debts.

(v) By making an excessive provision for contingencies or by continuing to carry forward provision even when they are not required.

Before the Companies Act, 1956 came into force, there were no restrictions on the creation of secret reserves except that whenever secret reserves were brought back into accounts, it was necessary to disclose the amount adjusted out of such reserves.

In the light of the provisions contained in Part III of Schedule VI to the Companies Act, 1956 requiring that a provision for depreciation, renewal or diminution in the values of assets and that in respect of a known liability which, in the opinion of directors, is in excess of the amount which is reasonably necessary for the purpose, should be credited to a Reserve, it is not any more possible for a company to create a secret reserve.

Note : Students may read the decision in the case *Rex vs. Kylsant and Moreland* to acquaint themselves with the circumstances which led to the introduction of restrictions on the creation of secret reserves.

6.3.2 Specific Reserves

A specific reserve is created for some definite purpose out of the profits of the company. The purpose may be any thing connected with the business which the Article of Association or the directors want to be provided for, such as dividend equalisation, replacement of fixed assets, expansion of the organisation, income-tax liability of the future, etc. Though the concerned amounts are carried under earmarked heads, these are available for distribution as dividend on the recommendation of the directors but subject to the approval of shareholders, since these are created by appropriation of profits.

There may be slight confusion since some of the objects for which specified reserves are created, may also appear to be covered by a charge against revenue, for example, provision for bad and doubtful debts as well as reserve for bad and doubtful debts or a provision for repairs and renewals running along with a reserve for an identical purpose. The only distinction between the two is based on whether it is a charge against revenue or an appropriation of profits. To create any specific reserve existence of profit is essential. Any amount which the directors desire to retain or the Articles require the company to retain over and above provision, necessary for a true and fair disclosure of profit, is specific reserve unless the same is retained for a general purpose, when it would become a general reserve.

Normally, specific reserves are created to comply with the terms of the Articles of Association or in accordance with a decision of the Board to meet a particular situation which may arise in the future. Also some of the specific reserves may be required under contractual obligations or legal compulsion. An example of the former would be the fund for redemption of debentures; that of the latter would be the development rebate reserve

which is compulsory if the advantage of the development rebate is to be enjoyed in respect of income-tax. Such specific reserves take on the character of capital reserves.

6.4 VERIFICATION OF ASSETS

6.4.1 General Principles

Verification of assets is an important audit process : by convention its scope has been limited to inspection of assets, where it is practicable, and collection of information about them on an examination of documentary and other evidence so as to confirm :

(a) that the assets were in existence on the date of the balance sheet ;

(b) that the assets had been acquired for the purpose of the business and under a proper authority ;

(c) that the right of ownership of the assets vested in or belonged to the undertaking ;

(d) that they were free from any lien or charge not disclosed in the balance sheet ;

(e) that they had been correctly valued having regard to their physical condition ; and

(f) that their values are correctly disclosed in the balance sheet.

Verification of assets is primarily the responsibility of the management since the proprietor or the officials of the entity are expected to have a much greater intimate knowledge of the assets of the business as regards location, condition, etc. than that which an outsider might be able to acquire on their inspection. They alone thus are competent to determine the values at which these should be included in the Balance Sheet. The auditor's function in the circumstances is limited only to an appraisal of the evidence, their inspection and reporting on matters affecting their valuation, existence and title, observed in the course of such an examination. Principally, the auditor is required to verify the original cost of assets and to confirm, as far as practicable, that such a valuation is fair and reasonable. As regards the manner in which the original cost should be ascertained, there are well defined modes of valuation which he is expected to follow.

Assets are valued either on a 'going concern' or a 'break-up value' basis. The first mentioned basis considered appropriate when the concern is working and the second, when it has closed down and is being wound-up. AS - 1 mentions that "Going Concern" is one of the fundamental accounting assumptions to be followed in preparation and presentation of financial statements. In case of non-observance, the fact that "Going Concern" assumption has not been followed is to be specified. If considered necessary, the auditor can also obtain the assistance of expert valuer. He must further ensure that the Balance Sheet discloses the basis on which different assets have been valued.

6.4.2 Valuation of Assets

Fixed assets are acquired for purpose of business with the object of earning revenue in the ordinary course of business ; these are intended to be used and not sold, *e.g.,* land, building, machinery, etc. Almost all fixed assets (except land and goodwill) suffer depletion or exhaustion due to efflux of time and their use or exploitation. In addition, almost all assets are subject to impairment taking into consideration its recoverable value in future. Mines and quarries are notable examples of the class of assets that are described as wasting assets, denoting that their value diminishes on exploitation, in contradistinction to the loss of value through use or obsolescence that takes place in the case of other assets. Floating assets are acquired for resale with a view to earning profits or are those that come into existence during the processes of trade or manufacture. All those, in the normal course of business, are quickly convertible into cash, *e.g.,* stock-in-trade, book debts, bills receivable, etc.

Fixed Assets : Fixed assets are included in the Balance Sheet at their cost less depreciation and impairment loss. Cost includes all expenditure necessary to bring the assets into existence and to put them in working condition. It would be incorrect to value them at their sale price since these are not intended to be sold. For the very same reason, the fluctuation in the market values are ignored even when these are permanent. If these were taken into account, it would result in either under or over allocation of their cost. In case any government grant has received in relation to specific fixed assets then either the grant can be shown as deduction from lost of the asset or grant can be treated as deferred income which is recognised in Profit and Loss Account.

Wasting Assets : More as a result of custom than financial expediency, no specific provision to reduce the value of wasting assets exists in the Companies Act, 1956. For the first time, this matter was considered by the Court in the case *Lee* v. *Neuchatel Asphalt Company Limited* and it was held that it was not necessary for a company to provide depreciation on wasting assets to arrive at the amount of profits which it could distribute. It cannot, however, be contended that the value of wasting assets remains unaltered despite their exploitation year after year. On a consideration of this position, the Institute of Chartered Accountants in England and Wales, as early as 1944, recommended that provision for depreciation or depletion should be made in respect of every wasting assets, such as mine, on the basis of the estimated physical exhaustion that takes place. The amount that must be provided can be determined on ascertaining the proportion that the quantity of the output during the year bears to the total quantity that the mine is expected to yield during its normal working life. The unit for such a computation should be the unit

of the refined produce and not that of the raw one. In terms of the clarification issued by the Company Law Board, it seems that even wasting assets need to be depreciated for the purpose of section 205 of Companies Act. Section 205(2)(*d*) of the Act covers cases in respect of which no rate of depreciation is provided by the Companies Act. On the very same consideration, if a mine has been acquired on a lease, the total amount paid for the lease should preferably be amortised over the period of the lease in proportion to the output in each year. This may sometimes appear impracticable; under such a situation, amortisation on a time basis may be considered.

Floating assets : In the case of these assets the attempt is to include them in the Balance-sheet at their realisable value. These, therefore, are valued either at cost or market value whichever is less. The term 'cost' refers to purchase price including duties and taxes, freight inwards and other expenditure directly attributable to acquisition less trade discount, rebates, duties drawbacks and subsidies, in the year in which they are accounted, whether immediate or deferred in respect of such purchase. The term 'market value' may either refer to "Net realisable value" or the replacement cost.

1. "*Net Realisable value*" : Net Realisable value is the estimated selling price in the ordinary course of business less estimated costs of completion and the estimated costs necessarily to be incurred in order to make the sale.

2. *Replacement Cost* : It refers to the price which would have to be paid for acquiring the same assets at the current market rate on the date of the Balance-sheet. The replacement cost is determined by taking into account the price that would have to be paid for purchasing the assets from normal sources of supply. In case free market for the assets does not exist it may not be possible to determine the replacement cost.

It may be noted here that in case of valuation of inventories, only net realisable value as a variant of market value has to be considered. This is in accordance with the Accounting Standard 2 (Revised) on 'Valuation of Inventories'.

Stock-in-Trade : It is a current asset held for sale in the ordinary course of business or in the process of production for such sale or for consumption in the production of goods or service for sale. The normally accepted accounting principle of valuation of stock-in-trade is at cost or net realisable value whichever is lower. This principle is in accordance with the AS 2 (Revised) on 'Valuation of Inventories'. This general principle applies to valuation of all inventories including stock-in-trade except inventories of the following to which special considerations apply.

(a) Work-in-progress arising under construction contracts, including directly related service contracts (see Accounting Standard (AS) 7 (Revised), "Accounting for Construction Contracts");

(b) Work-in-progress arising in the ordinary course of business of service providers;

(c) Shares, debentures and other financial instruments held as stock-in-trade; and

(d) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

The inventories referred to in (*d*) above are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral oils, ores and gases have been extracted and sale is assured under a forward contract or a Government guarantee, or when a homogenous market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this statement.

For instance, in the case of stock of tea, coffee and rubber, held by the plantations which have produced them, with a view to showing in their annual accounts the true profits in respect of each crop, it is valued at the date of the Balance Sheet at the price at which it has been sold subsequently, reduced either by actual or estimated selling expenses pertaining thereto. And where stocks are held for maturing (*e.g.,* rice, timber and wine), though their value increases substantially with the passage of time, these are usually valued at an amount which is equal to their cost *plus* storage charges. Where during storage the weight shrinks, an allowance for this factor is also made. In no case, however, the price applied is allowed to exceed the current market (selling) price of similar goods less costs necessarily to be incurred in order to make the sale.

Following the fundamental accounting assumption of consistency, whatever basis of valuation is adopted, it should be consistent from one period to another to prevent distortion of trading results disclosed by the annual accounts. Therefore, any change in the accounting policy relating to inventories (including the basis of comparison of historical cost with net realisable value and the cost formulae used) which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policy which has a material effect in the current period the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent

ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

Different connotations of 'Cost' : The significance of this term varies in different circumstances on account of the nature of goods and the methods by which cost has been computed. Essentially, it refers to an appropriate combination of the cost of purchase, cost of conversion and other costs incurred in the normal course of business in bringing the inventories up to the present location and condition.

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

(a) abnormal amounts of wasted materials, labour, or other production costs;

(b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

(c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) selling and distribution costs.

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs.

The cost of inventories, other than those dealt with in paragraph 14 of AS-2, should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Valuation of inventories below historical cost : The historical cost of inventories may at times not be realised, *e.g.,* if their selling prices have significantly declined, or if they become wholly or partially obsolete, or if the quantity of inventories is so large that it is unlikely to be sold/utilised within the normal turnover period and there exists a genuine risk of physical deterioration, obsolescence or loss on disposal. In such circumstances, it becomes necessary to write down the inventory to 'net realisable value,' in accordance with the principle of conservatism which requires that current assets should not be carried in the financial statements in excess of amounts expected to be realised in the ordinarily course of business. However, if materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there

has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value.

Disclosure : The financial statements should disclose :

(a) the accounting policies adopted in measuring inventories, including the cost formula used; and

(b) the total carrying amount of inventories and its classification appropriate to the enterprise.

Investments : Fundamentally, the basis of valuation of investments depends on the purpose for which these are held. If investments constitute a floating asset, these are valued at cost or at fair value whichever is lower. Where, however these are treated as a fixed asset *i.e.* an asset held to earn permanent income, these are valued at cost.

The Companies Act, 1956 has introduced a new concept - that of trade investments. These are investments made by a company in the shares and in debentures of another, not sufficiently large as to make the other a subsidiary. Such investments are always valued at cost since the basic consideration in making the investment associates in trade.

The market value of shares or debentures of a company which are not quoted on the Stock Exchanges in ascertained on a consideration of the financial position of the company as disclosed by its last Balance Sheet and Profit and Loss Account. For this purpose, the dividend policy and the price at which shares have changed hands in the previous months also are taken into account. It may, however, be noted that listing of all public issues have been made compulsory with the recognised stock exchange by the Companies (Amendment) Act, 1988.

Where shares or debentures have been acquired by a concern *in lieu* of services rendered in the promotion of a company (*e.g.,* in pursuance of an underwriting contract) or in the part payment of purchase consideration, these are included in the Balance Sheet at cost, determined on a reference to the relative agreement in pursuance whereof the allotment has been made. For example, where shares have been allotted in consideration of subscription obtained to loans or debentures, these are valued at the amount paid for them, reduced by the amount of underwriting commission earned; the shares allotted in pursuance to a vendor's agreement are valued at the price specified in the agreement. As per AS-13, the cost of an investment should include acquisition charges such as brokerage, fees and duties. If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities

issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities). The fair value may not necessarily be equal to the nominal or par value of the securities issued. If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

When an investment is sold for determining the amount of profit or loss resulting on its sales, it is necessary to first ascertain its cost. While doing so, a distinction is made between capital and revenue expenses and receipts. For instance the amount of brokerage paid on purchasing investment (Government Securities or debentures) is added to their cost. Costs such as transfer fees, stamp duty, etc. should be capitalised. But the amount, if any, paid on account of interest which had accrued due till the date of transaction is not taken into account for it is recoverable. Likewise, the value of bonus shares allotted subsequent to the purchase of the shares is not added to their cost. Then the cost of the original requisition would represent the cost for the total holding including bonus shares. However, the amount received on sale of 'right' in respect of new shares offered by the company may be deducted from the value of shares held, it being a capital receipt. On the very same consideration, any dividend received on shares for a period which had closed before the date of acquisition is treated as a capital receipt. As per AS-13, interest, dividend and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income. For example, when unpaid interest has accrued before the acquisition of an interest-bearing investment and is therefore included in the price paid for the investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; the pre-acquisition portion is deducted from cost. When dividends on equity are declared from pre-acquisition profits, a similar treatment may apply. If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

As per AS-13 on "Accounting for Investments, "an enterprise should disclose current investments and long term investments distinctly in its financial statements". Regarding valuation, it states as under:

"31. Investments classified as current investments should be carried in the financial statements at the lower of cost and fair value determined either on an individual investment basis or by category of investment, but not on an overall (or global) basis.

32. Investments classified as long term investments should be carried in the financial statements at cost. However, provision for diminution shall be made to recognise a decline, other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

33. Any reduction in the carrying amount and any reversals of such reductions should be charged or credited to the profit and loss statement.

34. On disposal of an investment, the difference between the carrying amount and net disposal proceeds should be charged or credited to the profit and loss statement."

6.4.3 General Principles Regarding Verification of Assets

(1) Where a company or a partnership has taken over the assets of a going concern, the agreement of sale should be inspected and that amount paid for them ascertained. It should be further verified that the allocation of the total cost among the various assets is fair and reasonable.

(2) The cost of assets acquired piecemeal should be verified with their invoices, purchase agreements or ownership rights and the receipt of the sellers in respect of the price paid. It should be verified that expenditure on assets newly acquired and that on the renewal and replacement of old assets has been correctly recorded, consistent with the method that has been generally followed in the past.

(3) When an asset is sold, its sale-proceeds should be vouched by reference to the agreement, containing the terms and conditions of sale, counterfoil of the receipt issued to the purchaser or any other evidence which may be available. If the sale of a fixed asset has resulted in capital profit, it should be transferred to capital reserve. However, the profit limited to the original cost or a loss should be transferred to the Profit & Loss Account.

(4) It is obligatory for a company to provide for depreciation out of the profits in accordance with the provisions under sub-section (1) of section 205, before any profits can be distributed as dividend. The law requires that depreciation should be provided in one of the ways specified in the section 205(2) of the Companies Act, 1956.

(5) The existence of fixed assets, where practicable, should be verified by a physical inspection and, or by comparing the particulars of assets as are entered in the Schedule attached to the Balance Sheet, with the Plant or Property Register and reconciling their total value with the General Ledger balances.

(6) Wherever possible, all the securities and documents of title, cash, negotiable instruments, etc. representing the assets, should be inspected at the close of the last day of the accounting period. If this be not practicable and the examination is undertaken at the later date, a careful scrutiny of transactions subsequent to the date of the balance sheet must be made to ensure that the changes in their balance that have subsequently taken place are *bonafide* and are supported by adequate evidence.

(7) It should be ascertained that no unauthorised charge has been created against an asset and all the charges are duly registered and disclosed. Where shares or securities are lodged with a bank to secure a loan or an overdraft, a certificate should be obtained from the bank showing the nature of the charge, if any.

(8) Where assets, *e.g.,* government securities, share scrips and debenture bonds are in the custody of a third party other than a bank, these must be inspected.

(9) Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

(10) According to the provisions contained in Part-I of Schedule VI to the Companies Act, 1956, the expenditure on fixed assets is required to be segregated under the following heads :

(a) Goodwill

(b) Land

(c) Buildings

(d) Leaseholds

(e) Railway sidings

(f) Plant and machinery

(g) Furniture and fittings

(h) Development of property

(i) Patents, trade marks and designs

(j) Livestock

(k) Vehicles, etc.

It is the duty of the management to ensure that the fixed assets of the company are in existence and for this purpose, it is important that physical examination of plant and machinery and other fixed assets should be carried out periodically depending upon the

size of the company. The order issued under section 227(4A) of the Act requires the auditor to report on the physical verification of the fixed assets by the management, and the treatment of the discrepancies, if any.

6.4.4 Audit of Fixed Assets

The Guidance Note on Audit of Fixed Assets issued by the ICAI recommends that the verification of fixed assets consists of examination of related records and physical verification. The auditor should normally verify the records with reference to the documentary evidence and by evaluation of internal controls.

The verification of records would include verifying the opening balances of the existing fixed assets from records such as the Schedule of fixed assets, ledger or register balances to acquisition of new fixed assets should be verified with reference to supporting documents such as orders, invoices, receiving reports and title deeds. Self-constructed fixed assets and capital work-in-progress should be verified with reference to the supporting documents such as contractors' bills, work orders and independent confirmation of the work performed from other parties. When fixed assets have been written off or fully depreciated in the year of acquisition, the auditor should examine whether these were recorded in the fixed assets register before being written off or depreciated. In respect of retirement of fixed assets, the auditor should examine whether retirements were properly authorised, whether depreciation accounts have been properly adjusted, whether the sale proceeds, if any, have been accounted for and the resulting gains or losses, if material, have been properly adjusted and disclosed in the profit and loss account. In case the asset has impaired the auditor must ensure that the asset has met the criteria as specified in AS 28, "Impairment of Assets". Further, if conditions so warrants the reversal norms of impairment loss are duly complied with.

The ownership of assets like land and buildings should be verified by examining title deeds. In case the title deeds are held by other persons such as bankers or solicitors, independent confirmation should be obtained directly by the auditor through a request signed by the client.

Physical verification of fixed assets is primarily a responsibility of the management. The management is required to carry out physical verification of fixed assets at appropriate intervals in order to ensure that they are in existence. However, the auditor should satisfy himself that such verification was done by the management wherever possible and by examining the relevant working papers. The auditor should also examine whether the method of verification was reasonable in the circumstances relating to each asset. The



reasonableness of the frequency of verification should also be examined by the auditor in the circumstances of each case. The auditor should test check the book records of fixed assets with the physical verification reports. He should examine whether discrepancies noticed on physical verification have been properly dealt with.

The auditor should see that the fixed assets have been valued and disclosed as per the requirements of law and generally accepted accounting principles. The auditor should test check the calculations of depreciation and the total depreciation arrived at should be compared with that of the preceding years to identify reasons for variations. He should particularly examine whether the depreciation charge is adequate keeping in view the generally accepted basis of accounting for depreciation. The Institute has also recommended that the company should provide depreciation so as to write off the asset over its normal working life. The company may provide depreciation at higher rate than the rates prescribed under Schedule XIV to the Companies Act, 1956, if it feels that the normal working life of the asset is low. However, if the company feels that the normal working life of the assets is much higher, it cannot provide depreciation at the rates lower than the rate prescribed by the Schedule XIV to the Companies Act, 1956. In such a case the rates given in Schedule XIV should be followed.

Re-valuation of fixed assets implies re-statement of their book values on the basis of systematic scientific appraisal which would include ascertainment of working condition of each unit of fixed assets. It would also include making technical estimates of future working life and the possibility of obsolescence. Such an appraisal is usually made by independent and qualified persons such as engineers, architects, etc. To the extent possible, the auditor should examine these appraisals. As long as the appraisal appears reasonable and based on adequate facts, he is entitled to accept the re-valuation made by the experts.

6.4.5 Fixed Assets and Requirements of CARO, 2003

(a) Clause 4(i) of CARO, 2003 requires the auditor to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets. What constitutes proper records is a matter of professional judgment made by the auditor after considering the facts and circumstances of each case. It is necessary that the aggregate original cost, depreciation or amortisation to date, and impairment loss, if any, as per these records under individual heads should tally with the figures shown in the books of account. It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account keeping (manual or computerized), the number of operating locations,

the systems of control, etc. It may be noted that with the advent of the information technology, many companies are maintaining electronic records. The auditor may, therefore, accept electronic fixed assets register if the following two conditions are satisfied:

(i) The controls and security measures in the company are such that once finalised, the fixed assets register cannot be altered without proper authorization and audit trail.

(ii) The fixed assets register is in such a form that it can be retrieved in a legible form. In other words, the emphasis is on whether it can be read on the screen or a hard copy can be taken. If this is so, one can contend that it is capable of being retrieved in a legible form.

In case the above two conditions or either of the two conditions are not satisfied, the auditor should obtain a duly authenticated print-out of the fixed assets register.

(b) Clause 4(i)(b) of CARO, 2003 requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable intervals. The clause further requires the auditor to comment whether any material discrepancies were noticed on such verification and if so, whether those discrepancies have been properly dealt with in the books of account.

Physical verification of the assets has to be made by the management and not by the auditor. It is, however, necessary that the auditor satisfies himself that such verification was done and that there is adequate evidence on the basis of which he can arrive at such a conclusion. The auditor may prefer to observe the verification, particularly when verification of all assets can be made by the management on a single day or within a relatively short period of time. If, however, verification is a continuous process or if the auditor is not present when verification is made, then he should examine the instructions issued to the staff (which should, therefore, be in writing) by the management and should examine the working papers of the staff to substantiate the fact that verification was done and to determine the name and competence of the person who did the verification. In making this examination, it is necessary to ensure that the person making the verification had the necessary technical knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible for verification to be made by outside expert agencies engaged by the management for the purpose.

The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be

realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land.

The Order requires the auditor to report whether the management "at reasonable intervals" has verified the fixed assets. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material.

(c) Clause 4(i)(c) of CARO, 2003 requires the auditor to comment, in case where a substantial part of the fixed assets has been disposed off during the year, whether such disposal has affected the going concern status of the company. The auditor, in the normal course, when planning and performing audit procedures and in evaluating the results thereof, is required to consider the appropriateness of the going concern assumption underlying the preparation of financial statements in accordance with the requirements of Auditing and Assurance Standard SA 570, "Going Concern". As a result of such audit procedures and evaluation, if the auditor is of the opinion that there exists any indication of risk that the going concern assumption might not be appropriate, the auditor should gather sufficient appropriate audit evidence to resolve, to his satisfaction, the question regarding the company's ability to continue operations for the foreseeable future. It may be noted that the sale of substantial part of fixed assets is one of the several such indications of risk. This clause of the Order pre-supposes the existence of

such risk and, therefore, requires the auditor to examine whether the company has disposed off substantial part of fixed asset(s) during the period covered by his report and, if yes, whether the disposal of such part of the fixed assets has affected the going concern status of company. It should also be noted that this requirement of the Order does not absolve the auditor from his responsibilities regarding the appropriateness of the going concern assumption as a basis for preparation of financial statements. Since there could be several other indications of such a risk, the auditor, notwithstanding his comments under the clause, should also comply with the requirements of SA 570, "Going Concern" while discharging his attest function. Sale of substantial part of fixed assets should be construed to have affected the going concern if the auditor is not able to resolve, to his satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future keeping in view the sale of substantial part of fixed assets or if the auditor comes to a conclusion that sale of substantial part of fixed assets has rendered the going concern assumption inappropriate. The Order does not define the word "substantial". The response to the issue as to what constitutes "substantial part of fixed assets" depends primarily upon the facts and circumstances of each case. The auditor should use his professional judgement to determine whether an asset or group of assets sold by the company is a substantial part of fixed assets. In this case, the auditor may note that section 293(1)(a) of the Act deals with the sale, lease or otherwise disposal of the whole or substantially the whole, of the undertaking of the company. It may be noted that such a situation may not necessarily tantamount to sale of substantial part of the fixed assets of the company. However, such an approval of the shareholders might be an indication that the company has sold or has the intention of selling substantial part of its fixed assets. The audit procedures, in such a case, would also include examination of the minutes of the general meeting(s) where the matter was discussed and the resolution passed by the shareholders in this regard. The auditor should carry out audit procedures to gather sufficient appropriate audit evidence to satisfy himself that the company shall be able to continue as a going concern for the foreseeable future despite the sale of substantial part of fixed assets. These procedures may include:

(i) discussion with the management and analysis as to the significance of the fixed asset to the company as a whole;

(ii) scrutiny of the minutes of the meetings of the board of directors and important committees for understanding the entity's business plans for the future (for example, replacement of the substantial part of the fixed asset disposed off with another fixed asset having more capacity or for taking up a more profitable line of business);

(iii) review of events after the balance sheet date for analysing the effect of such disposal of substantial part of fixed asset on the going concern.

The auditor should also obtain sufficient appropriate audit evidence that the plans of the management are feasible, are likely to be implemented and that the outcome of these plans would improve the situation. The auditor should also seek written representation from the management in this regard. Where the company has disposed off substantial part of fixed assets, the auditor should consider whether the disposal of such part of fixed assets has triggered the risk of going concern assumption being no longer appropriate. It is possible that such risk is mitigated by factors such as those referred to in (f)(ii) above. If, in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular because of management's plans for future action, the auditor, apart from reporting that sale of substantial part of fixed assets has not affected the going concern, should also consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed in the financial statements, but have not been adequately disclosed in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate in accordance with the requirements of Auditing and Assurance Standard SA 700, "The Auditor's Report on Financial Statements", issued by the Institute of Chartered Accountants of India.

6.5 VERIFICATION OF SPECIFIC ASSETS

6.5.1 Land and Buildings

Sometimes the two assets are shown together in the Balance Sheet. Nevertheless, their ledger accounts should always be separated particularly in view of the fact that buildings are subject to depreciation while land in general is not.

The land holdings should be verified by an inspection of the original title deed to ensure that the land described therein covers all the lands the cost of which is debited in the books of the concern. The auditor however, not being competent to verify the regularity of the title of the concern to the land, is not responsible for doing so. Therefore, generally, a certificate should be obtained from the legal adviser of the client confirming the validity of his title to the land. The auditor should, however, verify that the conveyance deed has been duly registered as required by section 17(1) of the Registration Act, 1908 also that particulars required to be endorsed thereon according to section 58 of the same Act have been duly made and verified. He should, in addition, generally ascertain that *prima facie* the title of the client does not appear to be defective.

If the property is mortgaged, the title deed would be in the possession of the mortgagee or his solicitors. A certificate to this effect should be obtained from them. It should also be ascertained whether there is any second or subsequent mortgage. If ground rents,

outstanding for recovery, are included in the Balance Sheet as an asset, the auditor must examine the counter parts of leases granted and also verify that the ground rents which were outstanding for recovery on the date of the Balance Sheet have since been recovered. If there has been any sale of land or building, it should be verified that he amount of profit or loss resulting on sale has been correctly adjusted in the accounts.

The cost of buildings, as is entered in the books, should be depreciated at appropriate rates, depending upon the quality of their structure and the use which is being made of them. The cost of fittings and fixtures to the building should be adjusted separately in the account from the cost of buildings, since these suffer higher rate of wear and tear than the brick and mortar structure and therefore, have to be depreciated at a higher rate.

If the values of land and buildings are not separately recorded in the books of account, the same should be separated for purposes of calculating the amount of deprecation. This should be done with the assistance of a valuer, unless the same can be achieved on the basis of some documentary evidence available in the record.

Since buildings are continually repaired and there is only a thin margin of differentiation between the expenditure of their improvement and that on repairs, it is necessary for the auditor to scrutinise closely the expenditure on repairs so as to exclude from its expenditure that could legitimately be considered to have added either to the life or the utility of the asset. Such an expenditure should be added to their cost while the amount incurred on current repairs is written off.

It is not customary to write up the book values of land and buildings even though their market values have increased but, where this has been done it will be necessary for the auditor to verify that the appreciation adjusted has been disclosed as required by the law. On the same consideration, no notice need be taken of any fall in the market value of such an asset until the same has crystallized by the asset being sold.

The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows :

(i) Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.

(ii) This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.

(iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.

(iv) Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.

(v) The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.

(vi) Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

6.5.2 Leasehold Property

Various steps involved in the verification of leasehold rights are stated below :

(a) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument (section 107 of the Transfer of Property Act, 1882).

(b) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.

(c) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.

(d) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.

(e) Ensure that the outlay as well as any legal expenses incurred to acquire the lease which are shown as an asset in the Balance Sheet are being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

A leasehold property, even where no premium has been paid for its acquisition, may some time come to have a considerable value. In such a case, it may not be advisable to

continue to show the asset as if it has no value. Nevertheless, where the leasehold rights have been revalued that fact should be clearly shown on the Balance Sheet till the account has been completely written off.

6.5.3 Building

If the building has been built or is in the course of construction, under a contract the auditor should verify the debit balance of the account by reference to the architect's certificate, as well as the contractor's receipts for amounts paid.

If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charged have been allocated to the account, is reasonable. The expenses charged should include all the expenditure necessary to bring the building into existence and to make it habitable. As a safeguard against any mistake arising in the expenses chargeable to the asset, the auditor should obtain a certificate from a responsible official in respect of total expenditure incurred on the construction of the building up to the date of the Balance Sheet. The amount of expenditure, where possible, should also be compared with the estimated cost of construction which may have been prepared by an architect or received with the tenders, if any, invited for construction. If there is a material discrepancy in the amount of actual and estimated expenditure, causes thereof should be reviewed.

6.5.4 Intangible Assets

An Intangible Asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licenses, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated. If an item covered does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of



purchase, it forms part of the goodwill recognised at the date of the amalgamation (see paragraph 55).

Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

As per AS-26, internally generated goodwill is not recognized as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

6.5.5 Plant and Machinery

In the absence of a Plant Register containing detailed particulars of various articles of machinery and equipment, showing separately original cost, addition to and sales from it from time to time. It is not normally practicable for the auditor to verify the existence of such assets. The auditors should therefore insist on a Plant Register being maintained where the value and variety of machinery and plant are substantial in comparison with the total assets of the business.

Where such a register is kept, it is customary to prepare at the end of each year a statement from the Plant Register showing opening balance, sale and addition thereto during the year in respect of various items of machinery and plant. Its total is then reconciled with the balance in the General Ledger.

The cost of addition, if any, is verified with the invoice of machinery supplied together with evidence in respect of other incidental expenses chargeable to the account, including

installation expenses. If any of the addition represents the cost of machinery manufactured by the concern with its own material and by its own labour, the basis on which the expenditure has been allocated should be verified. In addition, a certificate is obtained from the engineer responsible for the manufacture of the plant confirming the total cost of manufacture.

In case any item or machinery has been scrapped, destroyed or sold the auditor should ascertain that the profit or loss arising thereon has been correctly determined which has either been disclosed in the Profit and Loss Account or credited to the Capital Reserve. In appropriate circumstances, a certificate should be obtained from a senior official that this has been done.

Though it is the duty of the management to ensure that fixed assets are in existence, the auditor also should, periodically, physically examine various items of plant and machinery and other fixed assets, say, once in every three or five years, depending upon the size of the concern.

Certain companies, for convenience of inspection attach to each unit of plant and machinery a metallic disc bearing the number at which it is shown in the Plant Register.

When an asset has been revalued, depreciation should be provided on the revised value and not on the historical value.

6.5.6 Patterns, Dies, Loose Tools, etc.

Several entities have large investments in such assets which have a relatively short useful life and low unit cost. Evidently, it is a difficult matter, under the circumstances, to prepare a separate account for each such assets although a careful control over such property is necessary.

On these considerations, some entities charge off small tools and other similar items to Production Account as and when they are purchased and do not place any value on the unused stock on the Balance Sheet. Nevertheless, a record of issues and receipts of tools to workmen is kept, as a check on the same being pilfered and a memorandum stock account of dies and patterns is also maintained. In other concerns, the cost of tools, dies, etc. purchased is debited to appropriate assets account, and an inventory of the unused items at the end of the year is prepared and valued; the sum total of opening balance and purchase reduced by the value of closing stock, as disclosed by the inventory, is charged off to Production Account in respect of such assets. On the other hand, some concerns carry such assets at their book values at the end of the first year and charge off the cost of all the purchases in the subsequent year to the Production Account on the plea that they represent cost of replacement.

The most satisfactory method, however, is that of preparing an inventory of serviceable articles, at the close of each year, and revaluing the assets on this basis, the various articles included in the inventory being valued at cost. Care, however, should be taken to see that the inventory does not include any worn out or defective articles the life of which has already run out.

6.5.7 Furniture, Fittings and Fixtures

The cost of these assets should be verified by reference to the invoices of suppliers. All the expenditure incidental to their purchase also should be debited to the appropriate asset account. Further, the auditor should carefully scrutinise the details of the cost of additions debited to these accounts so as to ascertain that only the cost of genuine additions has been debited to such accounts. In the case of assets in regard to which there is a danger of loss through pilferage, there should be a satisfactory system of stock control over them. It requires that each article of furniture is entered in a Stock Register before its price is paid and the stock number under which it is entered is painted over it also that at the end of each period, an inventory is prepared and reconciled with the Stock Register and cost of all the articles which becomes unserviceable or have been lost is written off under proper authority.

6.5.8 Motor Lorries, Vans, etc.

The cost of these assets should be verified by reference to the invoices of suppliers and their ownership confirmed from permit and Registration Books. The auditor should also verify that the vehicles are covered by a comprehensive policy of insurance and adequate depreciation has been provided in respect of each of them. In case the number of vehicles is large, there should be a Vehicle Register similar to the Plant Register.

6.5.9 Livestock

A schedule of livestock at the close of the year should be obtained and entries in the same should be verified with the Register of Animals if it has been maintained. The entire stock of animals should be revalued on a uniform basis, from year to year, the cost of animals which have either been sold or have died during the year being excluded, and that of newly born or purchased during the year being added. There should be adjustment in the value of dry cattle on appropriate basis.

6.5.10 Ships

The cost of ships, if purchased outright, should be verified on a reference to the Bill of Sale and, if built to order, from the agreements with the shipbuilders. The ownership of the title should be verified from the certified copy of the entry in the port of registration unless the same is endorsed on the back of the Bill of Sale. Any mortgage or charge created on the ship is disclosed in the copy of 'entry' in case any exists, the same should be disclosed. In addition, it should be ascertained that the vessel is fully insured against all risks.

6.5.11 Investments

Investments are assets held by an entity for accretion of wealth by way of interest, royalties, dividends and rentals, for capital appreciation or for other benefits to the investing entity. It constitutes a significant portion of the total assets. An investment may be represented by Government securities, shares, debentures etc. The following procedure should be adopted for verifying the investments :-

(a) Obtain schedule of securities and share in hand at the beginning of the audit period containing description, date of purchase, face value, book value (also the amount paid up if it differs from the book value), market value, rate of interest, date of payment of interest, date around which dividend is normally declared etc. In separate columns enter the amounts of interest and dividend received during the period, interest or dividend accrued or outstanding at the close of the period, tax deducted out of the first mentioned amount and deductible out of the second.

(b) Add to the above list, securities and shares purchased and sold during the year, giving the same description in regard to both.

(c) Balance this schedule and compare the closing balance with the control account in the General Ledger.

(d) The auditor should ascertain whether the investments made by entity are within its authority.

(e) The auditor himself should also be satisfied that the transaction for the purchase/sale of investments are supported by due authority and documentation.

(f) The acquisition/disposal of investments should be verified with reference to the brokers' contract note, bill of costs, etc. special attention should be paid to investments purchased or sold cum-dividend, ex-dividend, cum-interest/ex-interest, cum rights/ex-rights or cum bonus/ex-bonus.

(g) Where the amount of purchases or sales of investments are substantial, the auditor should check the prices paid/received with reference to stock exchange quotations.

(h) The auditor should also physically inspect investments. The investments should be physically verified at the last date of the accounting year. In case investments are not held by the entity in its own custody - then certificate should be obtained from the relevant authority to the effect of holding of investments. (i) In case investments are held otherwise than in the name of the entity, e.g. in the name of nominees/trustees, the auditor should ascertain the reasons for the same and examine relevant documentary evidence.

(j) The auditor should also examine the relevant provisions of section 227(1A) and see that a company not doing an investment or banking company whether so much of the assets of the company as represented by shares and debentures have been sold at a price less than that at which they were purchased by the company.

(k) The auditor should see title deeds of immovable properties and see that same have been properly classified.

(l) The auditor should satisfy that the investments have been valued and disclosed in the financial statements in accordance with the recognised accounting policies and parties and relevant statutory requirements. Reference to principles laid down in AS-13 on "Accounting for Investments" relating to valuation of investments will be necessary.

(m) The auditor should examine whether in computing the cost of investments, the expenditure incurred on account of transfer fees, stamp duty etc. is included in the cost of investments.

(n) The auditor may also see that any money raised through share issue to the extent remains unutilised has been shown under the head "Investments" and the manner in which the same has been invested should also be indicated.

Note : About accounting of dividend income by companies, the Company Law Board has prescribed a procedure. In terms of the procedure, dividend declared during the accounting year even though not received should be accounted for in the same year. If dividend is declared after the year is over, but before the annual accounts are finalised and if the dividend relates to the accounting year, the same also should be accounted for in the year itself.

Section 49 of the Companies Act, 1956 requires that all investments made by a company on its own behalf shall be made and held by it in its own name except in cases which are specifically exempt. Clause (IA) of section 108 states that every instrument of transfer, before it is signed by or for the transferor should be presented, in a prescribed form, to a prescribed authority. The instruments should be stamped or the date of presentation or

otherwise endorsed thereon by the prescribed authority. Such an instrument should be delivered for registration to the company :

(a) In the case of shares which are dealt in or quoted on a recognised Stock Exchange at any time before the date on which the Register of Members is closed for the first time after the date of such presentation or within twelve months of such presentation whichever is later; and

(b) in any other case, within two months from the date of such presentation.

Its effects on the validity of the title to the shares held under bank transfer should be examined. Further, sections 108A to 108H should also be referred to.

Investment in the shares or debentures of a subsidiary : The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc. All the particulars entered in the schedule should be verified with the relevant account in the General Ledger. He should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.

The provisions contained in Part I, Schedule VI to the Companies Act, 1956 require that shares held in a subsidiary should be shown separately. The shares or debentures of a subsidiary are valued at cost. If the subsidiary has suffered a loss a provision for the proportionate part of the loss should be made in the accounts of the holding company.

6.5.12 Investment in the Capital of a Partnership Firm

This has now got to be disclosed separately. To establish the authenticity of this item the auditor should go through the partnership deed, noting the capital contributed by the company, and the latest Balance Sheet and the Profit and Loss Account, duly audited. The amount of the loss, if any, falling to the share of the company should be debited to the profit and loss account; the share of profit should be similarly credited to the Profit and Loss Account. The auditor should see whether the firm has been duly registered and he will do well to note the particulars sent for registration.

6.5.13 Patent Rights

The ownership of a patent is verified by inspection of the certificate issued in respect of grant of the patent. It has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are 'alive' and legally enforceable and renewal fees have been paid on due dates by being charged to revenue and to the Patent Account. The last renewal receipt should be examined to ascertain that the patent has not lapsed. If a number of patents are held, a schedule thereof should be obtained. The auditor should ensure that partners are being shown at cost less amortisation charges. The cost of a patent includes it purchase price and the registration cost if brought outright. If the patent has been developed by the client in-house, all development expenses, legal charges, including registration fees and other direct costs incurred in creating it, should be capitalized. The cost of patent should be written off over the legal term of its validity or over its useful commercial life, whichever is shorter. AS-26 has suggested ten years as useful life until and unless there is clear evidence that useful life is longer than ten years. As stated earlier, student may refer to AS-26 as well.

6.5.14 Trademarks and Copyright

The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verified that renewal fees have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortisation charges till date. If copyright and trademarks are generally revalued at cost less amortisation charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amoritsed over the period of legal validity or useful commercial life, whichever is shorter. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS-26 has suggested for every intangible assets useful life of ten years unless and until there is clear evidence that useful life is longer than ten years.

6.5.15 Endowment Policies

Endowment policies taken out for the redemption of leases, or sinking fund policies for the redemption of debentures and policies for other similar purposes, being in the nature of quasi-fixed assets, should be verified by inspection of the policies and the auditor should ascertain that the last premium on them has been duly paid.

6.5.16 Assets Abroad

Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document. Such a certificate must disclose unequivocally that they are free from any charge or encumbrance. The auditor should state in his report whatever evidence has been produced for this verification.

6.5.17 Development of Property

Expenses when incurred for the development of any property and which cannot be conveniently added to the value of such property should be capitalized under this head and written off over the period during which the benefit from such development will accrue to the business. Examples may be expenses incurred in grading and preparing the soil for plantations, overhead removal cost for collieries and mines, etc. These expenses should be verified with reference to the budgets, sanction of the appropriate authority, technical report, if any, and the bills for actual expenditure incurred. It should also be ensured that appropriate write off has been made against these assets, keeping in view the period of benefit or the exploitation, as the case may be.

6.5.18 Railway Siding

For verification of this item it would be essential to refer to agreement with Railway for availing of the facility. All expenses connected with the laying of the rails and making individual agreements, the amount paid to the Railway, if any should make up the cost. The cost of the railway siding should also be appropriately depreciated keeping in view the terms of agreement with the Railway, the permit or lease, if any, for the land used in providing the siding, etc.

6.6 CURRENT ASSETS

6.6.1 Stock-in-Trade

The valuation of stock is frequently the main factor in determining the result shown by the accounts. Apart from the effect on the Balance Sheet, incorrect treatment of stock would affect the profits of the year that has closed as well as that of the next following. The valuation of the closing stock, therefore, is an important step essential for the determination of the profits of the year and also for truly disclosing the financial position of the concern at the close of the year. An auditor being intimately concerned with these aspects of financial statements, it is his duty to verify the existence of the stock-in-trade possessed by the concern at the end of the year and to ascertain that the same has been valued correctly on a consistent basis.

The precise duties in regard to verification of stock-in-trade are nowhere defined. Under the circumstances, these have to be deduced from an interpretation of the general responsibility of auditors in regard to the statements of accounts verified by them, especially in regard to stock-in-trade. These have been considered in a few English decisions.

Justice Lindsay, while delivering the famous judgement in the case of *Kingston Cotton Mills Co. Ltd*. (1896) observed : It is no part of the auditor's duty to take stock. No one contends that it is so; he must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill, he must rely on some skilled person for the material necessary to enable him to enter the stock-in-trade as its proper value in the Balance Sheet.

In the same case, Justice Lopes observed as follows: "An auditor is not bound to be a detective, or as was said to approach his work with a foregone conclusion that there is something wrong. He is watchdog, but not a blood hound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest to rely upon their representations, provided he takes reasonable care."

In the case of the *Westminster Road Construction & Engineering Co. Ltd*. (1932), it was held that an auditor must make the fullest use of all materials available to him and although he is neither a stock-taker and nor a valuer of work-in-progress, he will be guilty of negligence if he fails to take notice of all available evidence from which it could be reasonably deducted that the work-in-progress was overvalued.

The decision thus appear to have settled the following three principles for the general guidance of the auditor :

(i) That it is no part of auditor's duty to take stock.

(ii) That for the purpose he can rely upon statements and reports made available to him in regard to the valuation of stocks so long as there is no circumstance which may arouse his suspicion and he is satisfied that the procedures in the matter of stock taking and management are such as would enable it to give such a certificate and that these have been followed.

(iii) That an auditor would be failing in his duty if he does not take reasonable care in verifying the statements of stock which are put up to him according to the information in his possession and the expert knowledge expected of him in regard to methods of verification and stock control.

The above view was almost accepted universally by accountants until as a result of the disclosures in the case of *McKesson and Robbins*, the auditors in the U.S.A decided to make physical contact with the inventories presented to them.

In United Kingdom, the situation also underwent a change in 1967 since the decision of the famous case in *Thomas Gerrard & Sons Limited*. The liquidator of Thomas Gerrard & Sons Limited succeeded in an action against the company's auditors. The Managing Director of the company manipulated cut-off procedures and included non-existent stocks in the accounts in order to pay huge dividends, which in fact were paid out of the capital. The auditors relied on the Kingston Cotton Mill unsuccessfully; because the learned judge pointed out that this decision also made reference to the absence of suspicious circumstances. In the instant case such circumstances were in plenty as many sales and purchase invoices at the year end had been deliberately altered. The Judge further observed that in these circumstances the auditors should reasonably have attended the stock taking.

Following this in 1968, the Institute of Chartered Accountants in England & Wales issued Auditing Statement U-9 advising positively that auditors should attend at stock taking for the purpose of observing the client's procedures and ensuring that they were likely to result in a reliable count. In this context it is also necessary to consider that during the last fifty years, there has been a great advancement in the techniques and methods of stock control. With the aid of modern methods of costing, accounting ratios and budgetary control, it is now possible to obtain more accurate information in regard to quantities and value of stock. Besides, now-a-days greater attention is being paid by businessmen to stock control and, as a result, the stock records maintained are more amenable to tests and checks.

The provisions in the Companies Act, 1956 have also considerably advanced the responsibilities of auditors in this regard. Section 209 of the Act requires a company to maintain proper books of account. Such books of account must, it is believed, include books kept to record transactions in stock-in-trade. The Act empowers the Central Government to require companies engaged in production processing, manufacturing or mining to maintain books as would furnish particulars in relation to utilisation of materials or labour or other items of cost as may be prescribed. Furthermore, by section 541(2) 'proper books of account' have been defined to include statements of annual stocktaking and (except in case of goods sold by way of ordinary retail trade) of all goods sold and purchased.

Part II of Schedule VI to the Act prescribes that the figures of opening and closing balances, of stock and work-in-progress be disclosed in the Profit and Loss account. Part I of the same Schedule requires that the mode of valuation of stock be shown on the Balance Sheet. Schedule VI requiring particulars or quantities of materials purchased, opening and closing stock and turnover is also of particular significance in this respect.

6.6.2 Verification of Inventories

The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. It is therefore the responsibility of the management of the entity to ensure that the inventories included in the financial information are physically in existence and represent all inventories owned by the entity. The management satisfies this responsibility by carrying out appropriate procedures which will include verification of all items of inventory at least once in every financial year. This responsibility is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence. Verification of inventories may be carried out by employing the following procedures :

(a) examination of records;

(b) attendance at stock-taking;

(c) obtaining confirmations from third parties;

(d) examination of valuation and disclosure; and

(e) analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgment of the auditor.

Examination of Records : The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item the receipts, issues and balances. The extent of examination of these records by an auditor with reference to the relevant basic documents (*e.g.,* goods received notes, inspection reports, material issue notes, bin cards, etc.) depends upon the facts and circumstances of each case.

6.6.3 Attendance at Stock-taking

Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, it may be appropriate for the auditor to attend the stock-taking. The extent of auditor's attendance at stock-taking would depend upon his assessment of the efficacy of relevant internal control procedures, and the results of his examination of the stock records maintained by the entity and of the analytical review procedures. The procedures concerning the auditor's attendance at stock-taking depend upon the method of stock-taking followed by the entity. There are two principal methods of stock-taking : *periodic stock-taking and continuous stock-taking.* Under the first method, physical verification of inventories is carried out at a single point of time, usually at the year-end. Under the second method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous stock-taking method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous stock-taking methods for certain stocks and carry out a full count of other stocks at a selected date. The auditor is expected to examine the adequacy of the methods and procedures of physical verification followed by the entity. Before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those stocks which have a high value either individually or as a category of stocks. Proper attention should also be paid to the

physical condition of inventories. Ideally, there should be no movement of stocks when the physical verification is being carried out. On occasions, however, it may be necessary for the entity to continue the production, receiving, or despatch operations during physical verification. In such circumstances, it is essential that the entity has the procedures to identify and record such movement. The auditor should review the procedures adopted by the entity to account for the movement of inventories from one location to another within the entity during stock-taking (*e.g.* issues from stores to production departments). The auditor should also examine whether the entity has instituted appropriate 'cut-off procedures' to ensure that -

(a) goods purchased but not received have been included in the inventories and the liability has been provided for;

(b) goods sold but not despatched have been excluded from the inventories and credit has been taken for the sales.

The auditor may examine a sample of documents evidencing the movement of stocks into and out of stores, including documents pertaining to period shortly before and shortly after the cut-off date, and check whether the stocks represented by those documents were included or excluded, as appropriate, during the stock-taking. The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, *e.g.*, stock statements submitted to banks. The auditor should examine whether the discrepancies noticed on physical verification have been investigated and properly accounted for. Where continuous stock-taking methods are being used by the entity, the auditor should pay greater attention to ascertaining whether the management :

(a) maintains adequate stock records that are kept up-to-date;

(b) has satisfactory procedures for physical verifications of inventories, so that in the normal circumstances the programme of physical verification will cover all material items of inventories at least once during the year; and

(c) investigates and corrects all material differences between the book records and the physical counts.

The auditor should determine whether the procedures for identifying defective, damaged, obsolete, excess and slow-moving items of inventory are well-designed and operate properly.

6.6.4 Confirmations from Third Parties

Where significant stocks of the entity are held by third parties, the auditor should examine that the third parties are not such with whom it is not proper that the stocks of the entity are held. The auditor should also directly obtain from the third parties written confirmation of the stocks held. Arrangements should be made with the entity for sending requests for confirmation to such third parties. Auditor should also consider SA 505, "External Confirmation" when he has obtained confirmation from third parties.

6.6.5 Examination of Valuation and Disclosure

The auditor's objective concerning valuation is to obtain evidence that the amount at which inventories have been valued is computed on an appropriate basis. The auditor should satisfy himself that the valuation of inventories is in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year. The generally accepted accounting principles involved in the valuation of most types of inventories are dealt with in Accounting Standard (AS) 2, of 'Valuation of Inventories' issued by the Council of the Institute of Chartered Accountants of India. The auditor should examine the methods of applying the basis of inventory valuation. Thus, with regard to determination of cost, the auditor should examine, *inter alia*, the stock sheets, records of physical verification, invoices, costing records and other relevant documents and also examine and test the treatment of overhead expenses as a part of cost of inventories. Wherever feasible, and particularly where only a single or a few major products are produced, the auditor may call for a reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books and review this reconciliation. Where standard costs are used or where overheads are charged at standard rates or percentages, he may ensure that appropriate adjustment is made to the inventories. The auditor should examine the evidence supporting the assessment of net realisable value. In this regard, the auditor should particularly examine whether appropriate allowance has been made for defective, damaged and obsolete and slow-moving inventories in determining the net realisable value. The auditor should satisfy himself that the inventories have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

6.6.6 Analytical Review Procedures

In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to inventories :

(i) reconciliation of quantities of opening stocks, purchases, production, sales and closing stocks;

(ii) comparison of closing stock quantities and amounts with those of the previous year;

(iii) comparison of the relationship of current year stock quantities and amounts with the current year sales and purchases, with the corresponding figures for the previous year;

(iv) comparison of the composition of the closing stock (for example raw materials as a percentage of total stocks, work-in-process as a percentage of total stocks) with the corresponding figures for the previous year;

(v) comparison of current year gross profit ratio for the previous year;

(vi) comparison of actual stock, purchase and sales figures with the corresponding budgeted figures, if available;

(vii) comparison of yield with the corresponding figure for the previous year;

(viii) comparison of significant ratios relating to inventories with the similar ratios for other firms in the same industry, if available;

(ix) comparison of significant ratios relating to inventories with the industry norms if available. It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out audit of inventories. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgment of the auditor.

6.6.7 Work-in-progress

The auditor may involve a technical expert in verification of work-in-progress if necessary. He may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date, particularly of items the production of which have been abandoned and for items the manufacture of which is not being actively undertaken provided cost sheets are available in respect of individual items or lots of jobs or work orders, which cannot be identified with physical work, these should be verified as follows :

(a) Ascertain that the cost sheets are duly attested by the Works Engineer and Works Manager.

(b) Test the correctness of the cost as disclosed by the cost records by verification of quantities and cost of materials, wages and other charges included in the cost-sheets by reference to the records maintained in respect of issues of materials, payment of wages and its classification and original evidence in respect of all expenditure included in the cost-sheets.

(c) Compare the unit cost or job cost as shown by the costsheet with the standard cost or the estimate of cost expected to be maintained under actual operating conditions during a limited future period (wherever these have been developed).

(d) Ensure that the allocation of overhead expenses has been made on reasonable basis and that total of the overhead expenses does not include any amount in respect of selling distribution and office expenses.

(e) Compare the cost-sheet in detail with that of the previous year both in regard to the composition of cost and the value placed on various components. If they vary materially, investigate the causes thereof.

6.6.8 CARO, 2003 and Inventory Requirements

(a) Clause 4(ii)(a) requires the auditor to comment whether the management has conducted physical verification of inventory at reasonable intervals. According to Accounting Standard (AS) 2, "Valuation of Inventories":

"Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."

Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, stores and spares, consumables and loose tools awaiting use in the production process. It may be noted that packing materials are also included in inventories. Inventories do not include machinery spares covered by Accounting Standard (AS) 10, "Accounting for Fixed Assets", which can be used only in connection with an item of fixed asset and the use of which is expected to be irregular. Physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases. It is, however,

necessary that the auditor satisfies himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can arrive at such a conclusion. For example, the auditor may examine the documents relating to physical verification conducted by the management during the year as also at the end of the financial year covered by the auditor's report. What constitutes "reasonable intervals" depends on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. The management of a company normally determines the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all the items of inventories should be verified by the management of the company at least once in a year. It may be useful for the company to determine the frequency of verification by 'A-B-C' classification of inventories, 'A' category items being verified more frequently than 'B' category and the latter more frequently than 'C' category items.

(b) Clause 4(ii)(b) requires the auditor to comment on the reasonableness and adequacy of the inventory verification procedures followed by the management of the company. In case the procedures of physical verification of inventories, in the opinion of the auditor, are not reasonable and adequate in relation to the size of the company and the nature of its business, the auditor has to report the same. An auditor should obtain reasonable assurance about existence and condition of inventories. Observation of physical verification/ examination of records of verification inventory is the primary source of evidence for the purpose of reporting under this clause. While the physical verification of inventories is primarily the duty of the management, the auditor is expected to examine the methods and procedures of such verification. The auditor may, if considered appropriate by him, be also present at the time of stock-taking. The duties and responsibilities of the auditor while attending a stock taking by the management are governed by the principles laid down in the Auditing and Assurance Standard SA 501, Audit Evidence – Additional Considerations for Specific Items, issued by the Institute of Chartered Accountants of India. The auditor should establish the reasonableness and adequacy of procedures adopted for physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement. There are two principal methods of physical verification of inventories: periodic and continuous. Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical

verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date. Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. The auditor while forming his opinion, in addition to finding answers to the illustrative questions for evaluating the internal controls mentioned in the Appendix IX of the Statement, employs several audit procedures, including examination of the reports of the internal auditor. The auditor has to use his professional judgement regarding the nature, timing and extent of the procedures to be applied in forming his opinion for commenting on this clause. The auditor can rely upon the work of an internal auditor provided the auditor complies with the requirements of Auditing and Assurance Standard SA 610, "Relying Upon the Work of an Internal Auditor", issued by the Institute of Chartered Accountants of India. The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking. The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., inventory statements submitted to banks. Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:

(i) maintains adequate stock records that are kept up-to-date;

(ii) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and

(iii) investigates and corrects all material differences between the book records and the physical counts.

The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly. The auditor may determine the reasonableness and adequacy of the procedures of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The following are the documents which can be examined by the auditor in this regard:

(i) written instructions given by the management to the concerned staff engaged in the verification process;

(ii) physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;

(iii) summary sheets/consolidation sheets duly authenticated by the responsible officials;

(iv) internal memos etc., with respect to the issues arising out of physical verification of inventory;

(v) any other relevant documents evidencing physical verification of inventory.

In case where the inventories are material and the auditor is placing reliance on the records, documents, information and explanations provided by the management, it would be desirable that the auditor, in order to substantiate the fact that the physical verification is carried out in accordance with the procedure explained by the management, attends the physical verification. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories. While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable or adequate.

(c) Clause 4(ii)(c) requires the auditor to comment whether the company is maintaining proper records of inventory. The clause also requires the auditor to comment whether any material discrepancies were noticed on physical verification of inventory and if so, whether those material discrepancies have been properly dealt with in the books of account. What constitutes “proper records” has not been defined. However, in general, records relating to inventories should contain, *inter alia*, the following:

(i) particulars of the item like nomenclature, nature, etc.

(ii) identification code of the item;

(iii) details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner;

(iv) relevant document number and department identification, if any;

(v) location.

If priced stores ledger is maintained, the records of the inventory should also disclose the prices at which the recording of the issues and receipts is made. The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents. The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained. In cases where a company is maintaining stock records for work-in-progress, say, for compliance with the requirements of the section 209(1)(d) of the Companies Act, 1956, the auditor would normally be able to obtain relevant information in respect of work-in-progress from such records. However, in many cases, it might be impracticable to maintain stock records for work-in-progress. In such cases, the auditor should consider the fact whether the company, at any point of time, can arrive or calculate the quantity and amount involved in the work-in-progress. Some of the factors that might be used in arriving at the value of work in progress include the production cycle, input/ output ratio analysis, production and stock records for the immediately following period. If the company is able to do so, the auditor may form an opinion that proper records relating to the work-in-progress have been kept and, accordingly, no adverse comment of the auditor under this clause would be required. However, before adopting this as an audit procedure, the auditor should satisfy himself as to the impracticability of maintenance of stock registers of work-in-progress. It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping (manual or computerized), the number of operating locations, the systems of control, etc. The Order further requires the auditor to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not

maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. If the item for which the discrepancy cannot be established is not material, the discrepancy, if any, will also not be material. For example, an item categorised as 'C' in ABC analysis might not be material and therefore, the discrepancy, if any, in regard to such an item would not be material. In other cases, however, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items to be specified.

6.6.9 Goods on Consignment

Where a separate account in respect of each consignment is not being maintained and only memoranda accounts in respect of goods sent on consignment are kept, the auditor should make sure that stocks sent out on consignment but unsold have been included in the closing stock; when a separate account in respect of each consignment is being maintained, the auditor should verify that the debit balance in each Consignment Account represents only the cost of unsold goods *plus* proportionate expenses incurred on their transport and transit insurance; also that a provision has been made or any damage or loss suffered by the stock or for a fall in sale price.

6.6.10 Goods on Approval

The auditor should ensure that any goods sent to customers on approval which were unsold at the close of the year have not been treated as sold and are shown in the account as Stock on Approval and are valued at lower of the cost or market value. In case they are reported to have suffered any damage, a provision for the same should be made.

6.6.11 Goods in Bond

Where some of the goods are in bond, it is usual to have separate stock sheets for them. The particulars of stock entered on them should be examined by reference to bond warrants. If the same are pledged with some bank, a certificate should be obtained from the bank. The bonded goods should be valued at cost or market value, whichever is less. The value placed on such stock should be counter-checked by reference to relevant invoices from foreign suppliers.

6.6.12 Contracts in Course of Completion

In the field of building construction, a contract may sometime extend over two or more years. When that happens, it is necessary to value the work-in-progress at the end of each year. In such a case, it would obviously be incorrect to value the work-in-progress at cost and postpone determination of profit to the year when the construction is finally completed and possession thereof made over, for it will lead to no profit being shown till the final year. Such a procedure will not be acceptable either to the shareholders or to the taxing authorities. One of the methods by which a part of profits can be included in the account of each year is the total profit anticipated in terms of percentage of total construction, computed in physical terms, completed each year. Such a procedure, however, may not yield a satisfactory result where the total income cannot be estimated accurately. In such an event, it is advisable to prepare cost statements and on that basis to compute value of work-in-progress at cost *plus* the part of the profit attributable thereto. As a general principle, it is imprudent to take credit for any anticipatory profit unless it is possible, reasonably and accurately, to estimate the amount. Even where this is practicable, the amount of profit should be estimated only in respect of instalments of contract price which has accrued or had been collected before the close of the year. In the case of contracts the construction of which is undertaken on the basis of 'cost *plus* percentage on cost' it would not be incorrect to take credit for the percentage of profit on cost actually incurred. For instance, if a factory is being built at 'cost *plus* 10% of cost basis' the process of incurring cost itself will establish a claim against the customer for the amount of such cost *plus* 10%. In such a case, it would not be incorrect to take credit for the whole of the profit which has actually accrued.

In the case of goods produced against a forward contract which are ready for delivery, the same should be valued at the price at which they will be delivered less expenses which will be incurred on their delivery. However, such a basis of valuation should not be adopted where there is any uncertainty regarding the terms of final settlement. For instance, where the buyer has to inspect the goods and he has the right to reject goods considered unsatisfactory, the contract price should not be applied until the goods have been inspected and approved.

6.7 BOOK-DEBTS

The term 'books debts' suggests particulary amounts recoverable from customers, but in practice it is applied to a wide range of claims which a business may carry as an asset in its books. Advances or loans cannot, however, be included under this head.

Verification of debtors may be carried out by employing the following procedures :

(a) Examination of records;

(b) Direct confirmation procedure (also known as 'circularisation procedure')

(c) Analytical review procedures.

The nature, timing and extent of audit procedures to be performed is, however, a matter of professional judgement of the auditor. The general procedure is as under :

6.7.1 Examination of Records

(i) The auditor should carry out an examination of the relevant records himself about the validity, accuracy and recoverability of the debtor balances. The extent of such examination would depend on the auditor's evaluation of the efficacy of internal controls.

(ii) The auditor should check the agreement of balances as shown in the schedules of debtors with those in the ledger accounts. He should also check the agreement of the total of debtor balances with related control account. Any differences in this regard should be examined.

(iii) Verification of subsequent realizations is a widely used procedure, even in cases where direct confirmation procedure is followed. In the case of significant debtors, the auditor should also examine the correspondence or other documentary evidence to satisfy himself about their validity and accuracy.

(iv) While examining the schedules of debtors with reference to the debtors' ledger accounts, the auditor should pay special attention to the following aspects :

  (a) Where the schedules show the age of the debts, the auditor should examine whether the age of the debts has been properly determined.

  (b) Where the amounts outstanding are made up of items which are not overdue, having regard to the credit terms of the entity.

  (c) Whether transfers from one account to another are properly evidenced.

  (d) Whether provisions for allowances, discounts and doubtful debts should recognise that even though a debtor may have confirmed the balance due by him, he may still not pay the same.

(*v*) The following are some of the indications of doubtful and uncollectible debts, loans and advances:

  (a) The terms of credit have been repeatedly ignored.

  (b) There is stagnation, or lack of healthy turnover, in the account.

(c) Payments are being received but the balance is continuously increasing.

(d) Payments, though being received regularly are quite small in relation to the total outstanding balance.

(e) An old bill has been partly paid (or not paid), while later bills have been fully settled.

(f) The cheques received from the debtors have been repeatedly dishonoured.

(g) The debt is under litigation, arbitration, or dispute.

(h) The auditor becomes aware of unwillingness or inability of the debtor to pay the dues, e.g., a debtor has either become insolvent, or has closed down his business, or is not traceable.

(i) Amounts due from employees, which have not been repaid on termination of employment.

(j) Collection is barred by statute of limitation.

(*vi*) Bad debts written off or excessive discounts or unusual allowances should be verified with the relevant correspondence. Proper authorization should be inspected.

(*vii*) In the case of claims made against insurance companies, shipping companies, railways, etc., the auditor should examine the correspondence or other available evidence to ascertain whether the claims have been acknowledged as debts and there is a reasonable possibility of their being realized. If it appears that they are not collectible, they should be shown as doubtful. Similar considerations apply in respect of claims for export incentives, claims for price escalation in case of construction contracts, claims for interest on delayed payments, etc.

(*viii*) The auditor should examine whether contingent liability, if any, in respect of bills accepted by customers and discounted with the banks is properly disclosed. He should also examine whether adequate provision on this account has been made, where required.

6.7.2 Direct Confirmation Procedure

(i) The verification of balances by direct communication with debtors is theoretically the best method of ascertaining whether the balances are genuine, accurately stated and undisputed, particularly where the internal control system is weak. The utility of this procedure depends to a large extent on receiving adequate response to confirmation requests. Therefore, in situations where the auditor has reasons to believe, based on his past experience or other factors, he may limit his reliance on direct confirmation procedure and place greater reliance on the other auditing procedures.

(ii) The auditor employs direct confirmation procedure with the consent of the entity under audit. There may be situations where the management of the entity requests the auditor not to seek confirmation from certain debtors. In such cases, the auditor should consider whether there are valid grounds for such a request. In appropriate cases, the auditor may also need to reconsider the nature, timing and extent of his audit procedures including the degree of planned reliance on management's representations.

(iii) The confirmation date, the method of requesting confirmations, and the particular debtors from whom confirmation of balances is to be obtained are to be determined by the auditor.

(iv) The debtors may be requested to confirm the balances either (a) as at the date of the balance sheet, or (b) as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity.

(v) The form of requesting confirmation from the debtors may be either (a) the 'positive' form of request, wherein the debtor is requested to respond whether or not he is in agreement with the balance shown, or (b) the 'negative' from of request wherein the debtor is requested to respond only if he disagrees with the balance shown.

(vi) The use of the positive form is preferable when individual account balances are relatively large, or where the internal controls are weak, or where the auditor has reasons to believe that there may be a substantial number of accounts in dispute or inaccuracies or irregularities.

(vii) The negative form is useful when internal controls are considered to be effective, or when a large number of small balances are involved, or when the auditor has no reason to believe that the debtors are unlikely to respond. If the negative rather than the positive form of confirmation is used, the number of requests sent and the extent of the other auditing procedures to be performed should normally be greater so as to enable the auditor to obtain the same degree of assurance with respect to the debtor balances.

(viii) In many situations, it may be appropriate to use the positive form for debtors with large balances and the negative form for debtors with small balances.

(ix) Where the number of debtors is small, all of them may be circularized, but if the debtors are numerous, this may be done on a sample basis. The sample list of debtors to be circularized, in order to be meaningful, should be based on a complete list of all debtor accounts. While selecting the debtors to be circularized, special attention should be paid to accounts with large balances, accounts with old outstanding balances, and customer accounts with credit balances. In addition, the auditor should consider accounts in respect of which provisions have been made or balances have been written off during the period under audit of earlier years and request confirmation of the balance without

considering the provision or write-off. The auditor may also consider including in his sample some of the accounts with *nil* balances. The nature of the entity's business (*e.g.*, the type of sales made or services rendered) and the type of third parties with whom the entity deals, should also be considered in selecting the sample, so that the auditor can reach appropriate conclusions about the debtors as a whole.

(x) In appropriate cases, the debtor may sent a copy of his complete ledger account for a specific period as shown in the entity's books.

(xi) The method of selection of the debtors to be circularised should not be revealed to the entity until the trial balance of the debtors' ledger is handed over to the auditor. A list of debtors selected for confirmation should be given to the entity for preparing requests for confirmation which should be properly addressed and duly stamped. The auditor should maintain strict control to ensure the correctness and proper despatch of request letters. In the alternative, the auditor may request the client to furnish duly authorised confirmation letters and the auditor may fill in the names, addresses and the amounts relating to debtors selected by him and mail the letters directly. It should be ensured that confirmations as well as any undelivered letters are returned to the auditor and not to the client.

(xii) Any discrepancies revealed by the confirmations received or by the additional tests carried out by the auditor may have a bearing on other accounts not included in the original sample. The entity should be asked to investigate and reconcile the discrepancies. In addition, the auditor should also consider what further tests he can carry out in order to satisfy himself as to the correctness of the amount of debtors taken as a whole.

(**Note:** Students may note that SA 505, "External Confirmation" also deals with the subject.)

6.7.3 Analytical Review Procedures

In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors, loans and advances:

(a) comparison of closing balances of debtors, loans and advances with the corresponding figures for the previous year;

(b) comparison of the relationship between current year debtor balances and the current year sales with the corresponding budgeted figures, if available;

(c) comparison of actual closing balances of debtors, loans and advances with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule with the corresponding figures for the previous year;

(e) comparison of significant ratios relating to debtors, loans and advances with similar ratios for other firms in the same industry, if available;

(f) comparison of significant ratios relating to debtors, loans and advances with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors, loans and advances. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgement of the auditor.

6.7.4 Disclosure

The auditor should satisfy himself that debtors, loans and advances have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

According to Part I of Schedule VI to the Companies Act, 1956, debts outstanding for more than six months have to be shown separately. Further, all the sundry debtors; loans/advances including those advanced to subsidiary companies are required to be classified as under :

(i) Debts considered good in respect of which the company is fully secured.

(ii) Debts considered good for which the company holds no security other than the debtor's personal security.

(iii) Debts considered doubtful or bad.

In addition, disclosure is also required of debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is partner or a director or a member. Debts due from other companies deemed to be under the same management have to be disclosed along with the name of the companies. Further, a note should be appended to show the maximum amount due by directors or other officers of the company at any time during the year.

6.7.5 Debts Requiring Special Consideration

(1) *Debts due in foreign currency* : In the case of debts in a foreign currency, the auditor should find out by converting the amount into home currency whether it is more or less than the amount shown as recoverable. If there is any deficiency or appreciation, it should be appropriately adjusted in the Profit and Loss Account.

(2) *Hire Purchase debts* : Strictly, these are not debts since the hirer has the option of returning the goods, the auditor should, therefore, confirm that the instalments of hire money which had accrued have been realised in case there are any arrears and the article which is the subject of hire purchase is still in the possession of the hirer, it should be necessary to set up a provision for the loss anticipated on sale of the asset or on account of non-recovery of the outstanding balance.

(3) *Package and empties* : If packages are returnable but the customer has not deposited any security against their return, it is possible that he may fail to return them. Against such a contingency, the auditor should ask the client to make a suitable provision.

6.7.6 Debt Due from Subsidiary Companies

Because of the close relationship existing between a holding and subsidiary company, it is necessary for an auditor to find out that the debts shown as outstanding from the subsidiary are genuine and have resulted from transactions entered into in the normal course of business. Therefore, the balance outstanding should not only be confirmed with the statements of account received from the subsidiary but its basis should also be inquired into. If the debt is covered by an agreement, the same should also be referred to. If any security is deposited against due repayment of advances the same should be inspected. Debts due from a subsidiary company should be disclosed duly classified in the same way as sundry debtors.

6.7.7 Bills Receivable

If possible, the auditor should attend on the last day of the accounting period to inspect the bills in hand and agree their total with the balance in the Bills Receivable Account. If verification is postponed till some time after the existence of the bills which had matured in between the two dates should be verified with the entries in respect of cash collected for them. If some bills were discounted after the date of the Balance Sheet, the collection of their proceeds should be verified. If any bills were dishonored after the date of the Balance Sheet, the auditor should ascertain what portion, if any, of the amount will not be recovered and ensure that provision for the same has been made. Where a new bill is

reported to have been taken in lieu of a bill which has matured, the auditor should inspect the bill. Where a number of bills are found to have been discounted before the close of the year the auditor should see that the amount of the bills so discounted is shown as a contingent liability on the Balance Sheet. If some of the bills are with bankers for collection, the auditor should obtain a certificate from them.

Generally, it will be the duty of the auditor to ensure that the bills were properly drawn and stamped and that they were not dishonoured. Where some of the bills were dishonoured, the auditor should ensure that they have been noted and protested.

6.7.8 Advances

These include amounts recoverable either in cash or in kind for value to be received, *e.g.,* rates, taxes and insurance. The auditor should obtain a list of all advances and compare them with balances in the ledger. He should ascertain that advances were made under proper authority and were being recovered regularly by agreed instalments. Where there is an agreement the same should be inspected. In the case of old balances, the auditor should ensure that provision has been made in respect of irrecoverable advances. Particulars mentioned above in respect of book debts must also be given for advances.

6.7.9 Loans

In general the procedure outlined in regard to debtors is also applicable in the case of loans (and advances). Apart from verification of the balances of loans, the auditor should inspect loan agreements and acknowledgements of parties in respect of outstanding loans. A loan or an advance, if material, can be granted only if authorised by the Memorandum and Articles of Association in the case of company. In addition, he should confirm that the loans advanced were within the competence of persons who had advanced the same, directors in the case of a company, partners in the case of a firm and trustees in the case of a trust. It should be verified that the loan has been acknowledged by the debtor and, in addition, he has executed a Pronote or a Bill of Exchange. If any security is deposited against due repayment of the loan, the same should be inspected. The loan should be classified for purposes of Balance Sheet in the same way as other debts. In addition, advances and loans to partnership firms in which the company or any of its subsidiaries is a partner, should be disclosed. Section 227(1A) specifically requires an auditor to inquire among other things whether :

(i) 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 interests of the company or its members; and

(ii) Loans and advances made by the company have been shown as deposits.

The Research Committee of the Institute of Chartered Accountants of India has given guidance for making inquiry as regards the above two matters. The guidance is on the following lines. The matter under clause (*i*) applies to loans and advances made by the company during the financial year under audit, whether they are outstanding on the date of the Balance Sheet or not. The inquiry should be made in the light of conditions prevailing when the loan or advance was made.

Loans and advances have not been defined anywhere in the Act. However, having regard to the requirement of clause (*ii*) above a distinction is obviously intended to be made between 'loans and advances' and 'deposits'. A deposit may be defined as the placing of money or money's worth with a third party, either for safe keeping or by way of security for the performance, of the depositor's obligations, or for the purpose of earning interest; in the last case the depositing with a party who customarily accepts deposits. Items required to be disclosed under the head 'Loans and Advances' in Part I of Schedule VI to the Act which do not fall within the above definition of a 'deposit' should be construed for the purpose of the clause (*i*) as "loans and advances."

Clause (*i*) applies to all loans and advances made 'on the basis of security' for this purpose would include any movable or immovable property, whether belonging to the borrower or not, of which either physical possession or over which a legally effective charge is given to the lender. In order to ascertain that loans and advances are "properly secured," auditors should make inquiries to ascertain that *prima facie* :

(a) the company holds a legally enforceable security, and

(b) the value of the security fully covers the amount of the loan or advance and is reasonably ascertained.

In order to comply with the requirements of paragraph (*a*) above, it will be necessary for the auditor to make appropriate inquires depending upon the type of security. A few instances are given below.

	Types of Security	Documents etc. to be Seen
(a)	Shares and debentures	The scrip and the endorsement thereon of the name of the transferee,in the case of transfer.
(b)	Government securities, and other securities, documents of title which are transferable by endorsement and delivery, *e.g.,* Bills of Lading and Railway Receipts.	The scrips or other documents duly endorsed in favour of the lenders.
(c)	Legal mortgage of immovable property.	Duly registered mortgage deed.

(d)	Equitable mortgage of immovable properties	Title deeds deposited.
(e)	Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(f)	Pledge of goods.	Appropriate record of goods held at the Balance Sheet date.
(g)	Hypothecation of goods.	Deed of Hypothecation or other document creating the charge, together with a statement of stocks held at the Balance Sheet date.

The valuation of securities which are quoted on a Stock Exchange would not normally present any problem. For securities which are not so quoted, the auditor should call for the last accounts of the company whose shares or debentures are deposited as securities and satisfy himself that *prima facie* the valuation placed on the securities or immovable property by the management is reasonable.

In the case of life insurance policies, the auditor shall call for evidence of the surrender value of the policy. In the case of stocks and other goods held on pledge or hypothecation, the auditor should ascertain that *prima facie* the valuation placed upon the goods is in order.

The loan agreement or correspondence in regard to the terms of the loan or advance should be seen. Where the loan or advance is made to a company, any charge on the assets of such a company should have been registered under section 125 of the Act in order to constitute an effective security.

Loans and advances on the basis of security would include loans or advances which are only partly secured from the commencement, or loans or advances which become partly secured owing to any reason, such as a fall in the value of the security. In the case of partly secured loans or advances, it would be advisable to show separately in the Balance Sheet as “Partly secured” including the extent to which they are secured.

The terms on which the loan or advance is made would primarly include the security, the interest charged and the terms of payment. It would be difficult to lay down any general principles regarding the rate of interest which may be charged on loans and advances. Various considerations such as the position and standing of the borrower, type of security, purpose of the loan, prevailing market rate of interest, etc. would be taken into account. If the loan has been given for business considerations, *e.g.,* loans to staff for purchase of

cars, house, etc. loans to suppliers of raw materials or other goods there may be justification for interest being charged at a rate lower than the market rate or even, in appropriate circumstances, no interest being charged at all. However, when a loan is given only with a view to earning interest, the interest charged should be at the commercial rate. Particular attention should be paid to loans or advances to concerns in which the directors of the company are interested.

The question whether the terms on which a loan or advance has been given are "prejudical to the interests of the company or its members" is a difficult one. Obviously, the auditor is not to inquire as to how such transactions of the company affect the interest of individual members (in their personal capacities). The reference to "members" should, therefore, be construed as a reference to the members of the company as a class, in their capacity as members. The members of company would be primarily interested in the reasonable return of their investment and the safety of their capital. The question whether a loan is prejudicial to the interest of the members should, therefore, be considered from this angle.

If a loan or advance has been approved by the members of the company and/or the Government as required by section 370 of the Act, this would be *prima facie* evidence to show that is not prejudicial to the interest of the company or members. It would appear that, in respect of a continuing loan or advance, the question whether the loan or advance is 'properly secured' would have to be considered at the end of each accounting year. However, the question whether a loan is "prejudicial to the interests of the company or its members" would have to be considered only at the time when the loan is given or renewed.

It should be noted that an inquiry has to be made as to whether loans and advances have been shown as deposits and not *vice versa*. It should be noted that a public company cannot grant loans to directors without the sanction of the Central Government unless the ordinary business of the company is that of making loans and advances.

6.8 BANK BALANCES

These should be verified by reference to bank reconciliation statement, and the balance certificates received from banks. If a Bank Reconciliation statement includes a large number of uncleared items as on the date of the Balance Sheet, the auditor should verify that the items were subsequently collected. On the other hand, where a cheque issued for more than six months before the close of the year is shown in the bank reconciliation statement, the entry has to be reversed.

If audit is undertaken long after the close of the year, the auditor should reconcile the bank balances right up to the date on which he undertakes the audit. The form of Balance Sheet contained in Part I of Schedule VI requires that the bank balance should be segregated as follows :

(i) With Scheduled Banks.

(ii) With Others.

In the last mentioned case, the nature of interest, if any, of a director or his relative with each of the bankers, should be disclosed.

Further, the nature of deposit in each case should be stated, *e.g.,* current, fixed call, etc. In the case of a non-scheduled bank, its name and the maximum balance that was held by it during the year should also be disclosed.

The auditor should satisfy himself that cash and bank balances have been valued and disclosed in the financial statements in accordance with recognized accounting policies and practices and relevant statutory requirements, if any. In this regard, the auditor should examine that following items are not included in cash and bank balances.

(a) Temporary advances.

(b) Stale or dishonoured of cheques.

Postage and revenue stamps, if material in amount, may be shown separately instead of being included under cash and bank balances.

6.9 CASH IN HAND

In a Balance Sheet all the under mentioned cash balance are included under the above head :

(a) cash balance in hand;

(b) petty cash balance in hand;

(c) balances of stamps in hand;

(d) cash in transit;

(e) cash at branches; and

(f) cash with agents;

The first three of the above mentioned are verified by actual count. The cash in transit and that with branches and agents is verified from documentary evidence available in regard thereto and the advice in respect of their subsequent remittance in whole or a part.

Special care is necessary in regard to verification of cash balances for unless they are checked by surprise there can be no certainty that the cash produced for inspection was in fact held by the custodian. For this reason, the cash should be checked not only on the last day of the year, but also checked again some time after the close of the year without giving notice of the auditor's visit either to the client or to his staff.

If there are more than one cash balances, *e.g.,* when there is a cashier, a petty cashier, a branch cashier and, in addition, there are imprest balances with employees, all of them should be checked simultaneously, as far as practicable so that the shortage in one balance is not made good by transfer of amount from the others. It is desirable for the cashier to be present while cash is being counted and he should be made to sign the statement prepared containing details of the cash balance counted. If he is absent at the time the cash is being verified, he may hold the auditor responsible for the shortage, if any, in cash. Such an attempt is known to have been made in the past.

If the auditor is unable to check the cash balance on the date of the Balance Sheet, he should arrange with his client for all the cash balance to be banked and where this cannot conveniently be done on the evening of the close of the financial year, it should be deposited the following morning. The practice should also be adopted in the case of balance at the factory, depot or branch where cash cannot be checked at the close of the year. In case this is not possible, the auditor should verify the receipts and payments of cash upto the date he counts the cash. This should be done soon after the cash balances have been counted. The Cash Book of the day on which the balance is verified should be signed by the auditor to indicate the stage at which the cash balance was checked. If any cheques or drafts are included in cash balance, the total thereof should be disclosed.

If there is any rough Cash Book or details of daily balance are separately kept, the auditor should test entries from the rough Cash Book with those in the Cash Book to prove that entries in the Cash Book are correct. If the auditor finds any slip, chit or I.O.U.s in respect of temporary advances paid to the employees included as part of the cash balance he should have them initialed by a responsible official and debited to Appropriate Accounts.

6.10 MISCELLANEOUS EXPENDITURE

This refers to expenditure essentially of a revenue nature which, instead of being charged off as and when it is incurred, is accumulated in an account appropriately headed to indicate its nature and the balance in the account is written off over a period of years during which its benefit is expected to accrue to the business. Examples of expenses are: prepaid expenses, discount allowed on subscription to debentures. As long as the

expense is not written off, it continues to appear as an asset on the right hand side of the Balance Sheet. Such expenses are described as Deferred Revenue Expenditure so as to indicate clearly the fact that though the expense is essentially of a revenue nature, its writing off has been deferred for adequate reasons.

For verification of such expenditure, it is necessary for the auditor to examine the evidence showing that the expense has actually been incurred as well as the proposed basis of its apportionment over a period of years. Wherever it is possible he must find out that the benefit of the expenditure which is being carried forward as an asset has not exhausted and, if so, the amount should be written off. If during the year any amount has been added thereto, the justification for the same should be examined.

Capitalisation of expenditure : Where a part of the expenditure, in respect of a period before the business had reached the revenue earning state, has been capitalized, the auditor should carefully examine that the amount so capitalized only represents expenditure which could be considered to have directly or indirectly contributed to bring into existence assets. It this connection, he should examine the resolution of the Board of Directors by which the capitalisation has been authorised and the amount capitalized should be disclosed in the Balance Sheet.

Students may note that with the issuance of AS-26 on Intangible Assets, the concept of miscellaneous expenditure would undergo a change. Para 55 of AS 26, "Intangible Assets" which deals with recognition of an expense requires than an expenditure on an intangible item should be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria, viz., future economic benefit, cost measured reliability, etc.

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. In this case, this expenditure should form part of the amount attributed to goodwill (Capital Reserve) at the date of acquisition.

The examples as prescribed in AS 26 of expenditure that are recognised as expenses are as under:

(a) expenditure on start up activities, unless this expenditure is included in the cost of an item of fixed asset under AS 10.

(b) expenditure on training activities.

(c) expenditure on advertisement and promotional activities.

(d) expenditure on relocating or re-organising part or all of an enterprise.

It should be further noted that, discount or premium relating to borrowing and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares can be treated as deferred revenue expenditure. Since, AS 26 does not apply to such item due to its specific nature.

6.11 VERIFICATION OF LIABILITIES

6.11.1 General Considerations

Liabilities are the financial obligations of an enterprise other than owners' funds. Liabilities include loans and borrowings, trade creditors and other current liabilities, deferred payment credits, instalments, payable under hire purchase agreements, and provisions. Besides liabilities, this Guidance Note also deals with contingent liabilities, i.e., obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. An important feature of liabilities which has a significant effect on the related audit procedure is that these are represented only by documentary evidence which originates mostly from third parties in their dealings with the entity.

Verification of liabilities is as important as that of assets, for, if any liability is omitted (or understated) or overstated, the Balance Sheet would not show a true and fair view of the state of affairs of the concern. For example, if the liability for certain expenses if found to have been omitted or understated, it would signify that against the revenue for the relative period, the full amount of expenses has not been charged. As a result, the figure of profit as disclosed by the Profit and Loss Account would be larger by the amount of the liability which has been omitted. Moreover, since the liability would not be included in the balance sheet, it would also be incorrect. Conversely, where a fictitious liability for expenses is adjusted in the accounts or when a liability is overstated, the result will be that the revenue would bear an increased charge which would have the effect of artificially reducing the profits. This will falsify the figure of profit or loss disclosed by the Profit and Loss account. Besides, on account of the inclusion of the liability, the Balance Sheet also will be false, since it would include an undisclosed 'secret reserve'. The auditor must, therefore, apart from vouching the entries in regard to the adjustment of liabilities, verify at the close of the year that the liabilities stated in the Balance Sheet are in fact payable and all its liabilities that could be traced by the exercise of the diligence and care on the part of the auditor have been accounted for. He must also obtain a certificate from a responsible official stating that to the best of his knowledge and belief, all liabilities, whether for purchases (supplies) or expenses or any other account existing at the date of

the Balance Sheet have been included in the books of account; also that all the contingent liabilities have either been disclosed in footnote to the Balance Sheet have been provided for.

It has been held, *inter alia,* in the case of the *Westminster Road Construction Engineering Co. Ltd.* (1932), that the auditor must take care to satisfy himself that all the expenses and liabilities which the company could be expected to have incurred have been brought into accounts. In the course of his judgment in this case, the learned judges observed :

"If the auditor found that a company in the course of its business was incurring liabilities of a particular kind and that the creditors sent in their invoices after an interval and that liabilities of the kind in question must have been incurred during the accountancy period under audit when he was making his audit, sufficient time has not elapsed for the invoices relating to such liabilities to have been received and recorded in the company's books, it becomes his duty to make specific inquiries as to the existence of such liabilities and also before he signed a certificate as to the accuracy of the Balance Sheet to go through the invoice files of the company in order to see that no invoice relating to liabilities has been omitted. The evidence has established to my satisfaction that no experienced auditor would have failed to ascertain the existence of the liabilities omitted from this Balance Sheet.

6.11.2 Loans and Borrowings

Verification of liabilities may be carried out by employing the following procedures:

(a) examination of records;
(b) direct confirmation procedure;
(c) examination of disclosure;
(d) analytical review procedures,
(e) obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls.

Loans and Borrowings

The auditor should satisfy himself that the loans obtained are within the borrowing powers of the entity.

The auditor should carry out an examination of the relevant records to judge the validity and accuracy of the loans.

In respect of loans and advances from banks, financial institutions and others, the auditor should examine that the book balances agree with the statements of the lenders. He should also examine the reconciliation statements, if any, prepared by the entity in this regard.

The auditor should examine the important terms in the loan agreements and the documents, if any, evidencing charge in respect of such loans and advances. He should particularly examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with.

Where the entity has accepted deposits, the auditor should examine whether the directives issued by the Reserve Bank of India or other appropriate authority are complied with.

In case the value of the security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

Where short-term secured loans have been disclosed separately from other secured loans, the auditor should verify the correctness of the amount of such short-term loans.

Where instalments of long-term loans falling due within the next twelve months have been disclosed in the financial statements (e.g., in parentheses or by way of a footnote), the auditor should verify the correctness of the amount of such instalments.

The auditor should examine the hire purchase agreements for the purchase of assets by the entity and ensure the correctness of the amounts shown as outstanding in the accounts and also examine the security aspect. Future instalments under hire purchase agreements for the purchase of assets may be shown as secured loans.

The deferred payment credits should be verified with reference to the important terms in the agreement, including due dates of payments and guarantees furnished by banks. The auditor should also verify the copies of hundies/bills accepted separately.

Trade Creditors and Other Current Liabilities: The auditor should check the adequacy of cut-off procedures adopted by the entity in relation to transactions affecting the creditor accounts. For example, the auditor may examine the documents relating to receipt of goods from suppliers during a few days immediately before the year-end and verify that the related invoices have been recorded as purchases of the current year.

The auditor should check that the total of the creditors' balances agrees with the related control account, if any; the difference, if any, should be examined.

The auditor should examine the correspondence and other relevant documentary evidence to satisfy himself about the validity, accuracy and completeness of creditors/acceptances.

The auditor should verify that in cases where income is collected in advance for services to be rendered in future, the unearned portion, not applicable to the period under audit, is not recognised as income of the period under audit but is shown in the balance sheet as a part of current liabilities.

While examining schedule of creditors and other schedules such as those relating to advance payments, unclaimed dividends and other liabilities, the auditor should pay special attention to the following aspects:

(a) long outstanding items;

(b) unadjusted claims for short supplies, poor quality, discount, commission, etc.;

(c) liabilities not correlated/adjusted against related advances;

(d) authorisation and correctness of transfers from one account to another.

Based on his examination as aforesaid, the auditor should determine whether any adjustments in accounts are required.

In case there are any unusual payments around the year-end, the auditor should examine them thoroughly. In particular, the auditor should examine if the entries relating to any such payments have been reversed in the subsequent period.

The auditor should review subsequent transactions to identify/confirm material liabilities outstanding at the balance sheet date.

6.11.3 Provisions

The term 'provision' means amounts retained by way of providing for depreciation or diminution in value of assets or retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy. Provisions include those in respect of depreciation or diminution in the value of assets, product warranties, service contracts and guarantees, taxes and levies, gratuity, proposed dividend etc. This Guidance Note, however, does not deal with provisions for depreciation or diminution in the value of assets.

The audit of provisions primarily involves examining the reasonableness and adequacy of the amounts provided for. The auditor should also examine that the provisions made are not in excess of what is reasonably required.

Provisions for Taxes and Duties: The adequacy of the provision for taxation for the year should be examined. The position regarding the overall outstanding liability of the entity as at the date of balance sheet should be reviewed. In respect of assessments completed, revised or rectified during the year, the auditor should examine whether suitable adjustments have been made in respect of additional demands or refunds, as the case may be. Similarly, he should examine whether excess provisions or refunds have been properly adjusted. The relevant orders received up to the time of audit should be considered and, on this basis, it should be examined whether any short provisions have been made good. If there is a material tax liability for which no provision is made in the accounts, the auditor should qualify his report in this respect even if the reserves are adequate to cover the liability.

If the entity disputes its liability in regard to demands raised, the auditor should examine whether there is a positive evidence or action on the part of the entity to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal under section 246 of the Income-tax Act, 1961. Where an application for rectification of mistake (e.g., under section 154 of the Income tax Act, 1961) has been made by the entity, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of tax is for a certain amount and the dispute relates to only a part and not the whole of the amount, only such amount should be treated as disputed. A disputed tax liability may require a provision or suitable disclosure (see Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date issued by the Institute of Chartered Accountants of India). In determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

In case the entity has made the provision for taxation on the basis of the tax-effect accounting method, the auditor should examine whether the method has been applied properly.

Provision for Gratuity: The auditor should examine whether the entity is required to pay gratuity to its employees by virtue of the provisions of the Payment of Gratuity Act, 1972 and/or · in terms of agreement with employees and, if so, whether provision for accruing gratuity liability has been made by the entity. The auditor should examine the adequacy of the gratuity provision with reference to the actuarial certificate obtained by the entity. In case the entity has not obtained such an actuarial certificate, the auditor should examine

whether the method followed by it for calculating the accruing liability for gratuity is rational.

Provision for Bonus: In the case of provision for bonus, the auditor should examine whether the liability is provided for in accordance with the Payment of Bonus Act, 1965 and/or agreement with the employees or award of competent authority. Where the bonus actually paid is in excess of the amount required to be paid as per the provisions of the applicable law/agreement/award, the auditor should specifically examine the authority for the same (e.g., resolution of the board of directors in the case of a company).

Provision for Dividends: The auditor should examine that dividends are provided for as per applicable provisions of the relevant laws and rules framed thereunder, relevant agreements and resolutions.

Other Provisions: Where provisions are made for liabilities that may arise on account of product warranties, service contracts, performance warranties etc., the auditor should examine whether the provisions made are in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, issued by the Institute of Chartered Accountants of India. The auditor should also examine the reasonableness of the basis adopted for quantifying the provision with reference to the relevant agreements.

6.11.4 Contingent Liabilities

The term 'contingent liabilities' refers to obligations relating to past transactions or other events or conditions that may arise in consequence of one or more future events which are presently deemed possible but not probable. Contingent liabilities may or may not crystallize into actual liabilities. If they do become actual liabilities, they give rise to a loss or an expense. The uncertainty as to whether there will be any legal obligation differentiates a contingent liability from a liability that has crystallized. Contingent liabilities should also be distinguished from those contingencies which are likely to result in a loss (i.e., a loss is not merely possible but probable) and which, therefore, require an adjustment of relevant assets or liabilities. Some of the instances giving rise to contingent liabilities are:

(a) law suits, disputes and claims against the entity not acknowledged as debts.

(b) membership of a company limited by guarantee.

The following general procedures may be useful in verifying contingent liabilities.

(a) Review of minutes of the meetings of board of directors, committees of board of directors/other similar body.

(b) Review of contracts, agreements and arrangements.

(c) Review of list of pending legal cases, correspondence relating to taxes, duties, etc.

(d) Review of terms and conditions of grants and subsidies availed under various schemes.

(e) Review of records relating to contingent liabilities maintained by the entity.

(f) Enquiry of, and discussions with, the management and senior officials of the entity.

(g) Representations from the management.

The auditor should verify that contingent liabilities do not include any items which require an adjustment of relevant assets or liabilities.

6.11.5 Examination of Disclosure

The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements. Where the relevant statute lays down any disclosure requirements in this behalf, the auditor should examine whether the same have been complied with.

In some cases loans are guaranteed by third parties in whose favour the assets of the entity are charged. The auditor should examine whether the disclosures concerning such loans are appropriate, e.g., they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

The auditor should examine that the following have been disclosed in respect of contingent liabilities:

(a) nature of each contingent liability;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect or a statement that such estimate cannot be made.

6.11.6 Analytical Review Procedures

In addition to the audit procedures discussed above, the following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions:

(a) comparison of closing balances of loans and borrowings, creditors, etc., with the corresponding figures for the previous year;

(b) comparison of the relationship between current year creditor balances and the current year purchases with the corresponding figures for the previous year;

(c) comparison of actual closing balances of loans and borrowings, creditors, etc., with the corresponding budgeted figures, if available;

(d) comparison of current year's aging schedule of creditors with the corresponding figures for the previous year;

(e) comparison of significant ratios relating to loans and borrowings, creditors, etc., with the similar ratios for other firms in the same industry, if available;

(f) comparison of significant ratios relating to loans and borrowings, creditors, etc. with the industry norms, if available.

It may be clarified that the foregoing is only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of liabilities. The exact nature of analytical review procedures to be applied in a specific situation is a matter of professional judgement of the auditor

6.11.7 Special Considerations in the Case of a Company

In addition to the procedures described above, the auditor should also employ the following procedures in the case of audit of a company.

(a) In determining whether the loans obtained by the company are within its powers, the auditor should scrutinise its memorandum and articles of association and also examine whether the provisions of sections 292 and 293(1(d) of the Companies Act, 1956 are complied with.

(b) The auditor should examine the register of charges to ensure that charges created have been duly registered. He should also ensure that the description of such charges disclosed in the balance sheet agrees in substance with that stated in the documents creating the charges.

(c) The auditor should examine all loans taken from bodies corporate under the same management or from a company, firm or other party in which any director is interested and determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prime facie prejudicial to the interest of the company.

(d) Where the company has accepted deposits, the auditor should examine compliance with the relevant legal provisions, e.g., section 58A of the Companies Act, 1956 and the rules framed thereunder/directions issued by the Reserve Bank of India.

(e) In respect of unclaimed dividends, the auditor should examine whether the company has complied with the provisions of section 205A of the Companies Act, 1956 and the rules framed thereunder regarding transfer of certain unpaid or unclaimed dividends to a special bank account/general revenue account of the Central Government.

(f) The auditor should examine whether any undisputed amounts payable in respect of income-tax, wealth tax. sales tax, customs duty and excise duty are outstanding as at the balance sheet date for a period of more than six months from the date they became payable. If so, the auditor should report the amounts of such outstanding dues.

(g) The verification procedure to be adopted by the auditor for audit of debentures would vary from year to year, depending upon whether fresh debentures are issued and/or they are redeemed or converted into shares during the year. In case of fresh issue of debentures, the auditor should examine the memorandum and articles of association of the company and resolutions authorising the issue. He should also examine compliance with the requirements of the terms of issue and any variations thereof and necessary approvals/clearances for · the issue from authorities concerned such as SEBI, RBI etc. The auditor should also examine that proper accounts are maintained with regard to amounts received towards application, allotment and calls and that the Payments by way of refunds/interest and all other relevant accounts are duly reconciled. Where debentures are issued at a premium/discount, the auditor should ensure that such sums are accounted for distinctly. In case of buy-back, conversion, re-issue or redemption of debentures, the auditor should examine that these are in accordance with the terms of the issue. The auditor should examine that the requirements relating to creation of debenture redemption reserve and, where applicable, sinking fund and its Investment; and other related requirements are complied with.

CARO, 2003 and Loan Requirements

There are seven clauses under paragraph 4(iii) of the Order. It is clarified that the auditor's comments on all the seven clauses are to be made with reference to the companies, firms or other parties covered in the register maintained under section 301 of the Act.

(a) Has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and [Paragraph 4 (iii)(a)]. The duty of the auditor, under this clause, is to determine whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If the company has done so, the clause requires that the auditor's report should disclose the "number of parties" and "amount involved" in such cases. The auditor is required to disclose the requisite information in his report in respect of all parties covered in the register maintained under section 301 of the Act irrespective of the period to which such loan relates. The clause covers not only the loan granted during the year but covers all loans including opening balances. Further, there is no stipulation regarding the loan being given in cash or in kind. In the absence of such stipulation, the auditor is required to disclose the requisite information in his report in respect of all kind of loans whether given in cash or in kind to the parties covered in the register maintained under section 301 of the Act. Under section 301 of the Act, every company is required to maintain one or more registers which contain the particulars of all contracts or arrangements to which section 297 or section 299 of the Act applies. The particulars of contracts and arrangements required to be entered in the register maintained under section 301 include, among other things, names of the parties to the contract or arrangement. The auditor should obtain a list of companies, firms or other parties covered in the register maintained under section 301 of the Act from the management. The auditor should examine all loans (secured or unsecured) granted by the company to identify those loans granted to companies, firms or other parties covered in the register maintained under section 301 of the Act. It may so happen that a party listed in the register maintained under section 301 of the Act might take a loan from the company and repays it to the company during the financial year concerned. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared-up during the year and report such transactions under the clause. For example, the company has, during the financial year, granted a loan of Rs. 1,00,000/-to a firm in which one of the directors of the company is interested and the firm repays the loan during the financial year concerned. The auditor is also required to consider such transaction while commenting upon this clause of the Order. Apart from reporting the number of parties, the auditor is also required to disclose the "amounts involved". Since the Order does not clarify what constitutes "amounts involved" it would be proper if the auditor discloses the maximum amount involved during the year in the transactions covered by this clause. While commenting upon this clause, the auditor may also consider whether the year-end balance should also be disclosed in his audit report.

(b) Whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and [Paragraph 4 (iii)(b)]. This clause, read with Paragraph 4(iii)(a) of the Order, requires the auditor to examine and comment whether the rate of interest and other terms and conditions of loans given by the company (whether secured or unsecured) to companies, firms or other parties covered in the register maintained under section 301 of the Act are prima facie prejudicial to the interest of the company. The auditor should examine agreements entered into by the company with the parties covered in the register maintained under section 301 of the Act or any other supportive documents available for ascertaining the rate of interest and other terms and conditions of all loans granted by the company to such companies, firms or other parties. The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans given are prima facie prejudicial to the interest of the company. The "other terms" would primarily include security, terms and period of repayment and restrictive covenants, if any. In determining whether the terms of the loans are "prima facie" prejudicial, the auditor would have to give due consideration to a number of factors connected with the loan, including its ability to lend, borrower's financial standing, the nature of the security, prevailing market rate of interest and so on. It may be mentioned that clause (a) of sub-section (1A) of section 227 of the Act also requires the auditor to inquire 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 interests of the company or its members. The auditor's inquiry under the aforesaid clause may also be useful for the purposes of reporting under this clause. Further, the auditor may also come across a situation where the company has a policy of providing loans at concessional rates of interest to its employees and such a loan has been given to a relative of the director who is also an employee of the company. In such a case also, the auditor would be required to examine and comment whether loan is prejudicial to the interests of the company. It may, however, be noted that normally such rate of interest as per the policy followed by the company cannot be said to be prejudicial to the interest of the company if other employees of the company also receive the loan at the same rate of interest.

(c) Whether receipt of the principal amount and interest are also regular; and [Paragraph 4 (iii)(c)]. This part of the clause requires the auditor to report upon the regularity of receipt of principal amount of loans and interest thereon. Again, read with paragraphs 4(iii)(a) and (b) of the Order, the scope of auditor's inquiry under this clause shall be restricted in respect of companies, firms or other parties covered in the register



maintained under section 301 of the Act. The auditor is required to comment on this clause in regard to receipt of principal amount of loans "granted" by the company to companies, firms or other parties covered in the register maintained under section 301 of the Act. The auditor has to examine whether the receipt of principal amount and interest is regular. The word 'regular' should be taken to mean that the principal and interest should normally be received whenever they fall due, respectively. If a due date for receipt of interest is not specified, it would be reasonable to assume that it falls due annually. A loan repayable on demand falls due as and when the lender calls back the loan. The auditor can make an assessment of the regularity only if the loan is demanded by the company since the question of regularity would be judged by consequent action of the company (payment or non-payment). If the lending company has not called back the loan, the auditor cannot comment under this sub-clause. The following are some of the procedures that the auditor may apply to report on the clause:

(i) the auditor, while obtaining an understanding of the terms and conditions for reporting under paragraph 4(iii)(b) of the Order, should also take note of repayment schedule;

(ii) if loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of receipt of interest, for example, letters of understanding, acknowledgement by the party of the terms and conditions communicated by the company, etc.;

(iii) the dates of receipt of principal amount and payment of interest needs to be verified with reference to the books of accounts of the company to come to the conclusion whether such receipts are regular; and

(iv) if the results of the procedures mentioned above indicate any irregularity in receipt of principal and/or interest, the auditor should mention the fact in his report.

(d) If overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest. [Paragraph 4(iii)(d)]. This clause requires the auditor to state whether reasonable steps have been taken by the company for recovery of the principal and interest, wherever the overdue amount is more than rupees one lakh. A loan is considered to be overdue when the payment has not been received on the due date as per the lending arrangements. In such cases, the auditor has to examine the steps, if any, taken for recovery of this amount. It may, however, be noted that the scope of the auditor's inquiry under this clause is restricted to loans given by the company to parties covered in the register maintained under section 301 of the Act. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, the

degree of delay in recovery and other similar factors, issue of reminders or the sending of an advocate's or solicitor's notice, may amount to "reasonable steps" even though no legal action is taken. The auditor is not, therefore, required to comment adversely on the mere absence of legal steps if he is otherwise satisfied that reasonable steps have been taken by the company. The auditor should ask the management to give in writing, the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations. The auditor should obtain sufficient appropriate audit evidence to support the fact that reasonable steps have been taken for recovery of the principal and interest of loans taken/granted by the company.

(e) Has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and [Paragraph 4(iii)(e)].

(f) Whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured; are prima facie prejudicial to the interest of the company; and [Paragraph 4(iii)(f)]. The auditor should examine agreements entered into by the company with the parties covered in the register maintained under section 301 of the Act or any other supportive documents available for ascertaining the rate of interest and other terms and conditions of all loans taken by the company from companies, firms or other parties covered in the register maintained under section 301 of the Act. The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans taken are prima facie prejudicial to the interest of the company. The "other terms" would primarily include security, terms and period of repayment and restrictive covenants, if any. In determining whether the terms of the loans are "prima facie" prejudicial, the auditor would have to give due consideration to a number of factors connected with the loan, including the company's financial standing, financial position, availability of alternative sources of finance, urgency of borrowing, ability to borrow, the nature of the security given, prevailing market rate of interest and so on.

(g) Whether payment of the principal amount and the interest are also regular. [Paragraph (4)(iii)(g)]. The following are some of the procedures that the auditor may apply to report on the clause:

(i) the auditor, while obtaining an understanding of the terms and conditions for reporting under paragraph 4(iii)(g) of the Order, should also take note of repayment schedule;

(ii) if loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of repayment and payment of interest, for example, letters of

understanding, acknowledgement by the party of the terms and conditions communicated by the company, etc.;

(iii) the dates of repayment of principal and payment of interest needs to be verified with reference to the books of account of the company to come to the conclusion whether the repayments of principal and payment of interest are regular; and

(iv) if the results of the procedures mentioned above indicate any irregularity in payment of principal and/or interest, the auditor should mention the fact in his report.

6.11.8 Debentures

Directors of a company in exercise of the powers vested in them may raise a loan by issue of debentures with or without creating a charge on the assets of the company. Debenture holders do not carry any voting right. When a charge is created over some of the assets, debentures are described as mortgage debentures. The terms and conditions on which the loan is raised, together with particulars of property charged as security for their repayment are printed on the debenture bonds along with a certificate showing that the charges have been registered with the Registrar. It is also customary to create a trusteeship in favour of one or more persons whenever some property belonging to the company is charged as security for repayment of the debentures. The trustees have all the powers of a mortgagee of the property and can act in whatever way they think expedient to safeguard the interest of the debenture holders. By the inclusion of section 119 in the Companies Act, 1956, the trustees of debenture holders now are expected to show the same degree of care and diligence in the administration of the debenture trusts as is required of other trusts. They cannot avoid such liability which they could do before. Both the members and debenture holders, if they so desire, can obtain a copy of the trust-deed from the company. Debentures, once redeemed, can always be reissued subject to restriction contained in section 121 (1) of the Act. The inclusions of section 117A, 117B and 117C has made compulsory for the appointment of trustees and creation of reserve for redemption of debentures by the Companies (Amendment) Act, 2000.

The debenture bonds are issued to various debenture holders and entries in respect thereof are made in the books of account in exactly the same way as in the case of shares. Therefore, the amount received on issue of debentures should be vouched in the same way as the amount received on issue of capital. Apart from this various steps involved in the verification of debentures are stated below :

(a) Prepare a schedule of debenture holders with reference to the Register of debenture holders and tally the total amount received from debenture holders in respect of different

classes of debentures that are outstanding for payment with the total of debentures as shown in the General Ledger.

(b) Study the Memorandum and Articles of the company to ascertain the borrowing powers of the company ; also whether any limitation has been placed thereon. In addition, it should be verified whether the limit on borrowing imposed by the provision of section 229(1)(d) is operative or has been relaxed by a resolution of the shareholders.

(c) Inspect a copy of the debenture bonds that have been issued in acknowledgement of amounts received to ascertain the terms of repayment and particulars of the assets charged as security for the repayment of the amount ; and verify that all the requirements of the Act relating to their issue have been fully complied with.

(d) See in the case of mortgagee debentures, that the obligations undertaken by the company under the debentures trust deed to the debenture holders were being strictly honoured.

(e) Confirm that the undermentioned information, required by law, has been duly communicated to the Registrar of Companies :

  (i) Particulars of charges which have been created over the assets of the company (Section 125).

  (ii) Particulars in case of series of debentures entitling holder pari passu (Section 128).

  (iii) Information in regard to commission or discount paid on subscription of debentures (Section 129).

  (iv) Information in regard to satisfaction in whole, or in part, of any charge relating to the property of the company (Section 138).

(f) Verify that the provisions regarding redemption has been duly complied with. Debentures may be redeemable according to the terms of issue at specified dates by annual or other drawings or, at the option of the company, after due notice has been given of the intent to repay. While vouching entries in respect of debentures redeemed, the minutes of the Board of Directors authorising their redemption should be referred to for authority and the cancelled debenture bonds of stock certificates should be examined.

If some debentures have been purchased in the open market, it should be seen that these are being shown as an investment of Sinking Fund if that is the case, in the Balance Sheet. Any surplus arising on redemption of debentures is capital profit. The balance left to the credit of the Sinking Fund Account, in excess of the value of debentures redeemed on account of profit made on sale of securities held as an investment of the Sinking Fund or due to debentures having been redeemed at a discount, would also be capital profit. However, according to Clause 3(*xii*)(*b*) of Part II to Schedule VI of the Companies Act, it is necessary to disclose the amount of such profits in the Profit and Loss Account of the

company. When it is transferred directly to the Capital Reserve Account a note should be added to the Balance Sheet to disclose that fact.

If the debentures are redeemed at a premium, the amount of the premium should be written off by debit to the Profit and Loss Account.

If a Sinking Fund for redemption of debentures is being operated by means of an insurance policy it should be verified that the policy has been duly assigned in favour of trustees for debenture holders.

Debentures are treated as secured loans in the matter of disclosure of security provided against their repayment. The condition of redemption together with the earliest date it shall take place, are also disclosed.

If the company has redeemed certain debentures which it is authorised to reissue, particulars thereof also are disclosed. Likewise, when any debentures are held by a nominee or trustee for the company, their nominal amount is disclosed together with the issue price (Part I, Schedule VI). As in the case of other loans, the provision for interest accrued but not matured for payment, is shown separately under the head 'Current Liabilities and Provisions' but that accrued and payable is shown along with the debentures. Such a distinction is made on the ground that whereas the first mentioned interest is a provision, the second is a debt.

Debenture Trust Deed: *The Companies (Amendment) Act, 2000 has introduced sections 117A, 117B and 117C to protect the interests of debenture holders. These requirements are in addition to requirements of SEBI as well. Section 117A requires compulsory creation of debenture trust deed while section 117B deals with appointment of debenture trustees and duties thereof. Section 117C requires a company to create security and debenture redemption reserve.*

***CARO, 2003 Requirements*:** The auditor, under Clause 4(xix) of the Order is required to examine whether the company has created any 'security' or 'charge' for the debentures issued by it. The auditor is required to comment upon the creation of security or charge in respect of debentures issued by the company by creating proper charges on the assets of the company. Where the company has issued any debentures, the auditor should also examine the debenture trust deed executed under section 117A of the Act. The auditor should pay particular attention to verify whether proper security has been created in favour of the debenture trust. The security creation can be verified by examining the relevant documents creating the charge in favour of the trustees for the debentureholders duly registered in the concerned Registrar's office if the security is an immovable

property. Readers' attention is also invited to the Guidance Note on Certification of Documents for Registration of Charges issued by the Institute of Chartered Accountants of India. If the debentures have been issued towards the end of the year and the securities are created subsequently then, to present a complete and balanced picture while reporting the fact that the security in respect of debentures is yet to be created, the auditor would be well advised to also mention the reason for the same, viz., that the debentures have been issued only recently (specify the month of issue) and that the company is taking steps to create the security. However, he should report as above only where, as a result of his enquiries, he is satisfied that the non-creation of security is not due to deliberate or inadvertent delay on the part of the company and that it is in fact in the process of creation of security.

6.12 CONTINGENT LIABILITIES

Accounting Standard 29 issued by the ICAI deals with the "Provisions, Contingent Liabilities and Contingent Assets". According to it a contingent liability is (a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or (b) a present obligation that arises from past events but is not recognized because: (i) it is not probable that an outflow of resource embodying economic benefits will be required to settle the obligation; or (ii) a reliable estimate of the amount of the obligation cannot be made. According to this statement, the contingent liabilities are not recognized because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future event not wholly within the control of the enterprise. In addition, the term "contingent liability is used for liabilities that do not meet the recognition criteria.

As per above definition, to be called contingent liability the following condition must be fulfilled: (a) possible obligation as a result of past event; (b) existence of which will be confirmed only by the occurrence or non-occurrence of future event; and (c) future event not wholly within the control of the enterprise.

An obligation is a possible obligation if based on the evidence available, its existence at the balance sheet date is considered not probable.

Recognition Principles of Contingent Liability: An enterprise should not recognize the contingent liability but it should be disclose in financial statement, unless the possibility of an outflow of resource embodying economic benefit is remote. In some cases an enterprise is jointly and severally liable for an obligation in that case, the part of the

obligation that is expected to be met by other parties is treated as contingent liability. Contingent liabilities are continuously assessed and if it become probable that an outflow of future economic benefit will be required to settle obligation which is previously assessed as contingent liabilities, a provision is recognized.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, para 68 of AS 29 an enterprise should disclose for each class of contingent liability at the balances date.

- A brief description of the nature of the contingent liability and where practicable.
- An estimate of the amount as per measurement principle as prescribed for provision in AS 29.
- Indication of the uncertainty relating to outflow.
- The possibility of any reimbursement. If it is not practicable to disclose these brief, note that effect.

The Companies Act, 1956 requires disclosure of following liabilities by way of a note :

(1) Claims against the company not acknowledged as debts.

(2) Uncalled liability on shares partly paid.

(3) Arrears of fixed cumulative dividend.

(4) Estimated amount of contracts remaining to be executed on capital account and not provided for.

(5) Other money for which the company is contingently liable.

The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature of each such contingent liability, if material shall also be specified.

The apprehended liabilities aforementioned usually are not easy to ascertain unless a comprehensive knowledge in regard to the working of the business is acquired from a study of the Minute Book of Directors, files of correspondence with legal advisers and on collection of information from the officials of the company in regard to undisposed claims and legal actions pending against the company.

6.13 EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

Accounting Standard - 4 on "Contingencies and Events occurring after the Balance Sheet Date" deals with the treatment of contingencies and events occurring after the balance sheet date in financial statements. According to it, events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and in the case of any other entity by the corresponding approving authority. Some of such events may require adjustments to assets and liabilities as at the balance sheet date or may require disclosure. These are classified as under:

(a) Adjusting events are those significant events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date, *e.g.,* an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of the customer which occurs after the balance sheet date or that indicate that the fundamental accounting assumptions of going concern (*i.e.,* the continuance of existence or substratum of enterprise) is not appropriate.

(b) Non-adjusting events are those events which do not relate to conditions existing at the balance sheet date. An example is the decline in the market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in the market value do not normally relate to the condition of the investments at the balance sheet date but reflects circumstances which have occurred in the following periods. However, disclosure is generally made of such events in case these represent unusual changes affecting the existence or sub-stratum of the enterprise at the balance sheet date. For example the destruction of a major production plant by a fire after the balance sheet will not require any adjustment in the balance sheet as no conditions existed on the date of the balance sheet. They may be of such significance that they may be required disclosure in the report of the approving authority. Representing material changes and commitments affecting the financial position of the enterprise. In case disclosure of events occurring after the balance sheet is required, the auditor should see that the following information has been provided :

    (i) the nature of the events; and

    (ii) an estimate of the financial effect or a statement that such an estimate cannot be made.

(c) There is another category of events which although take place after the balance sheet date are required to be reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared after the balance sheet in respect of the period covered by the financial statements.

6.14 PRIOR PERIOD AND EXTRAORDINARY ITEMS AND CHANGES IN ACCOUNTING POLICIES

The objective of AS-5 on the above subject is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

This Statement does not deal with the tax implications of extraordinary items, prior period items, change in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Net Profit or Loss for the Period

All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss :

(a) profit or loss from ordinary activities, and

(b) extraordinary items.

Prior Period Items

Prior period items are income or expenses which arise in the current period as a result of errors or commissions in the preparation of the financial statements of one or more prior periods.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

Extraordinary Items

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

When items of income and expense within profit and loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Profit or Loss from Ordinary Activities

When items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with the above paragraph include :

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Changes in Accounting Estimates - In preparation of financial statements, it is inevitable to estimate certain items due to inherent uncertainties in business activities. For example estimates may be required of bad debts, inventory obsolescence or the useful lives of depreciable assets.

A change in accounting estimates is not equivalent to change in accounting policy. For example change from straightline method to WDV method would amount to change in accounting policy to a change in useful life would be treated as change in accounting estimate.

The effect of a change in an accounting estimate should be included in the determination of net profit or loss in :

(a) the period of the change, if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Changes in Accounting Policies - As per AS-1, consistency is one of the fundamental accounting assumptions. Moreover, users should be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

A change in an accounting policy should be made only if the adoption of a different accounting policy is required by status or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

Any change in an accounting policy which has a material effect should be disclosed. The impact of and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

Self-examination Questions

1. State which of the following statements are true:

   (i) An expenditure which is not revenue is capital.

   (ii) If revenue expenditure is treated as capital, the profit of the year is overstated but, in the long run because of depreciation, there is no effect on profits.

   (iii) Distinction between capital and revenue expenditure is not relevant for short duration ventures.

   (iv) Expenditure resulting in the acquisition of a tangible property is capital even if there is no income from the property.

   (v) Loss due to a heavy fall in prices of finished products should be treated as deferred revenue expenditure.

   (vi) Expenditure on labour always built up skills benefitting future production ; hence, a part of it is at least deferred expenditure.

   (vii) Deferred revenue expenditure includes loss arising from an event beyond one's control.

   (viii) Secret reserves strengthen financial position, hence they are allowed.

   (ix) Interest included in the hire purchase price is revenue expenditure.

   (x) If, because of some expenditure, the cost of production falls, it is a capital expenditure.

   (xi) The rate of depreciation is not important since sooner or later the full cost of the asset is bound to be written off.

   (xii) Providing for depreciation in the case of companies is not compulsory if the company does not wish to pay dividend.

   (xiii) Under the two methods of depreciation the Straight Line Method and the Diminishing Value Method, the life assumed is the same.

   (xiv) A company adopting the Straight Line Method will report lower profit in later years compared to the company adopting the other method.

   (xv) Section 205 of the Companies Act does not allow dividends to be paid unless past losses are first made good.

   (xvi) For ascertaining profits on which managerial remuneration is based, depreciation will be according to the Straight Line Method.

(xvii) Reserve for taxation means sums set aside to meet the tax liability in respect of the current year.

(xviii) Capital profits realised in cash may be distributed as dividend, provided the Articles do not prohibit ; hence profit on reissue of forfeited shares may be distributed.

(xix) Specific reserves are capital profits since the amount concerned can be utilised only for the specified purpose.

(xx) Making provision by debit to the Profit and Loss Account for all the liabilities and losses arising out of transactions already entered into is essential.

***Answer** : [(ii) ; (iii) ; (iv) ; (vii) ; (ix) ; (x) ; (xii) ; (xiii) ; (xiv) ; (xx) ;]*

2. State which of the undermentioned are correct :

(i) Verification of assets means establishing their physical existence and ownership as also their usability but not their valuation.

(ii) An auditor must see that in case of all assets the mode of valuation as also the present market value is disclosed in the Balance Sheet.

(iii) An asset over which a mortgage has been created should not be stated in the Balance Sheet since property in it has passed to the mortgagee.

(iv) Trade investments are fixed assets.

(v) Trade investments are fixed assets and should be shown as such in the Balance Sheet.

(vi) Current assets are shown at net realisable value in the Balance Sheet but not exceeding their cost.

(vii) It is not legally compulsory to provide depreciation on wasting assets.

(viii) Trade investments are fixed assets and hence is sufficient to show them at cost even if there is a big fall in their value.

(ix) In the case of a contractor, machinery acquired for a contract is a current asset.

(x) The Base Stock Method of valuing stock amounts to treating it like a fixed asset.

(xi) Adjusted selling price is the normal method of valuing stocks of plantation products.

(xii) property let out on rent need not be depreciated.

(xiii) The total depreciation provided on an asset over its life will be same whatever the method.

(xiv) Over the life of a fixed asset, 90% of its cost has to be written off.

(xv) The fall in the value of a fixed asset, except for depreciation, does not concern the auditor even if it has become obsolete.

(xvi) The cost of know-how paid for acquiring plant and machinery should be added to its cost but not that for operating it.

(xvii) Land and building have to be shown separately in the balance sheet.

(xviii) Goodwill is as much subject to depreciation as any other asset and should be written off over its life to the extent of 95% as required by section 205.

(xix) It is the management's duty to periodically inspect plant and machinery and other fixed assets; the auditor need not do so.

(xx) It is necessary to indicate the fact if an asset is acquired on hire purchase basis.

(xxi) Patents and trade marks should be written off over five years.

(xxii) It is sufficient if the auditor obtains a certificate from management in respect of stock-in-trade.

(xxiii) The rules regarding valuation and verification of stock-in-trade do not apply to partnership concerns.

(xxiv) The auditor must see the Goods Inward and Goods Outwards Book for the subsequent period to establish the accuracy of the stock in trade.

3. Correct the misconception if their be any, in the statements made below :

(a) Provision for taxation is a settled liability.

(b) Provision for taxation includes accrued municipal taxes.

(c) Provision for taxation is checked by the auditor with reference to the demand note issued by the Department.

(d) The basis for the computation of tax provision for a year is the past assessment records in the possession of the company.

(e) Tax provision for the year is an appropriation of profit.

(f) Companies pay wealth tax.

(g) Income-tax includes capital gains tax.

(h) Provision for taxation for the year is created in the books of a company.

(i) Provision for taxation should be arrived at after deducting double taxation relief, if any.

(j) Amounts of sales tax paid may be vouched with reference to the treasury receipts obtained making payments.

(k) Registered dealers are the assessees for the purpose of Sales-tax Act.

(l) A company cannot create a reserve, except a statutory reserve unless it is authorised to do so by Articles of Association.

(m) Proposed dividends must be shown separately in the Balance Sheet.

(n) Debentures once redeemed cannot be re-issued.

(o) Debentureholders are like the shareholders.

4. Contingent liabilities can be ascertained with reference to the following :-

(a) Entries in the books of prime entry.

(b) Previous years Balance Sheet.

(c) Minute Book of the Board of Directors.

(d) File containing miscellaneous correspondence.

(e) File containing reference to lawyers.

(f) Director's Report.

(g) Permanent audit maintained by the auditor.

(h) Investment Register

(i) Endorsements on the share certificates held as investments.

(j) Guarantee documents executed.

(k) Court's orders (not contested).

(l) Assessment orders (contested).

(m) Actuarial computation in respect of the gratuity payable to the employees.

(n) Purchase orders placed.

(o) Records with the Registrar of Companies.

5. How would you vouch and/or verify the following?
   (a) Cash Sales
   (b) Income-tax Payment
   (c) Assets acquired under Hire-purchase System
   (d) Borrowings from Bank
6. How will you vouch and/or verify the following?
   (i) Preliminary expenses
   (ii) Sale of assets
   (iii) Purchase returns
   (iv) Bills payable
7. State briefly how you would verify the following Assets :
   (1) Plant and Machinery
   (2) Live-stock
   (3) Patent Rights
   (4) Fixed Assets Abroad
8. State how the following Investments of a limited company should be valued and disclosed in its Balance Sheets :
   (a) Investments of Reserve Fund
   (b) Investments in Subsidiary company for trade purpose.
   (c) Temporary investments of idle working capital.
   (*d*) Investments pledged with banks are securities for loan
9. What are the special points to which an auditor should direct his attention for ascertaining the adequacy of provision for Bad and Doubtful Debts in the context of proper valuation of sundry debtors?

10. State briefly how would you verify the following :
    (a) Goodwill
    (b) Provision for Income-tax
    (c) Copy Rights
    (*d*) Cash-in-transit
11. State how would you verify, any *two* of the following :
    (i) Leasehold Property
    (ii) Customs and Excise Duty
    (iii) Outstanding Expenses
12. How would you verify the following ?
    (a) Buildings
    (b) Borrowings from Banks
    (c) Railway Siding
    (d) Contingent Liabilities
13. How will you vouch/verify the following. While auditing the accounts of a company :
    (a) Research and Development Expenditure
    (b) Sale Proceeds of Rejected Materials
    (c) Contingent Liabilities
    (d) Purchase of Quoted Investments
14. How would you verify the following items in the books of account of a company which you are auditing?
    (a) Goodwill
    (b) Amounts due to, a subsidiary company
    (c) Loans given against the security of Land
    (d) Loans given against the security of Goods

15. "Physical presence of the auditor at the time of year end verification of stocks is though not always possible, it is recommended that he should at least be present as an observer. "Signify the importance of this statement and list out the important aspects which the auditor should look into to ensure an effective physical verification programme.

16. Your client has sought your opinion to correctly account for and/or disclose the following matters. State your views with reasons for the same :

    (a) The amount payable to suppliers of machinery under deferred payment arrangements have been shown as current liabilities. The company accepted the bills drawn by the supplier and offered its other fixed assets as a collateral security.

    (b) The debit balance in the profit and loss account is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet.

    (c) Sundry debtors include charges made for returnable packing cases.

    (d) The value of land building was not separately disclosed. Also a major repair of the roof amounting to Rs. 1,00,000 was carried out during the year, without which the building would have become unusable.

    (e) Assets purchased under hire-purchase system were reflected at their full value and the outstanding instalments payable have been included under Sundry Creditors.

17. How would you verify the following?

    (i) Work-in-progress

    (ii) Outstanding liabilities for expenses.

18. How would you verify and vouch the following?

    (a) Remuneration paid to directors

    (b) Research and development expenditure

    (c) Discounted bills receivable dishonored

    (d) Consignment sale

19. How would you vouch and/or verify the following ?

    (i) Consignment transactions in the books of consignee

    (ii) Interest and Dividends received

    (iii) Goodwill

    (iv) Contingent Liabilities

20. What are the general considerations for valuation and verification of assets ?

21. State with reasons, how the following items should be allocated to capital and revenue :

    (i) Repairs to building done shortly after purchase

    (ii) Costs of raising a loan.

22. State your views on the following:

    (a) Events occurring after the Balance Sheet Date.

    (b) Verification, valuation and disclosure of fixed assets.

Multiple Choice Questions

1. Which of the following expenses should not be treated as capital expenditure ?
   (a) Expenses paid on installation of a plant.
   (b) Cost of dismantling a building in case a new building is to de constructed on the land.
   (c) Legal expenses incurred to defend a suit related to title of a patent. The suit has been lost.
   (d) The fees paid to engineer who constructed the plant.
2. Which of the following is not a revenue expenses ?
   (a) Cost of raising a loan
   (b) Cost of accessories of motor vehicles spent at the time of purchase
   (c) Expenses incurred for laying of sewers on land purchased
   (d) Insurance premium paid at the time of registration of the ship.
3. Depreciation does not arise from --
   (a) Effluxion of time
   (b) use
   (c) obsolescence through technology and market changes
   (d) Market expectations
4. Which of the following schedule of the companies Act, 1956 deals with depreciation ?
   (a) Schedule XIV
   (b) Schedule V
   (c) Schedule XIII
   (d) Schedule X

5. Schedule XIV has prescribed rates of depreciation for double shift and triple shift working for which one of the following assets ?

   (a) Building

   (b) Plant and Machinery

   (c) Furniture and fittings

   (d) Ships

6. If the book value of an asset stands at ……Per cent of the original cost, a company need not provide depreciation on it.

   (a) Two

   (b) Fifteen

   (c) Five

   (d) Ten

7. A company has bought patents. Which of the following methods is most suitable for providing depreciation on them ?

   (a) SLM

   (b) WDV

   (c) Sum-of-year digits

   (d) Any of the above

8. Which of the following is a revenue reserve ?

   (a) Capital redemption reserve

   (b) Security premium account

   (c) Debenture redemption reserve

   (d) Capital reserve

9. Which of the following will not lead to creation of secret reserve ?

   (a) Undervaluation of closing stock

   (b) Charging capital expenditure to revenue

   (c) Goods sent on consignment being shown as actual sales

   (d) Charging higher rates of depreciation on fixed assets than actually required.

10. According to part I, Schedule VI of the Companies Act,1956 reserves are shown under the head 'Reserves and Surplus'. There are seven sub-heads mentioned under it by the Act. While one of the following is not a category of reserve mentioned under 'Reserves and surplus' ?

    (a) Capital redemption reserve

    (b) Surplus

    (c) Reserve fund

    (d) Sinking fund

11. Which of the following is not true with regard to verification of assets?

    (a) It invoices substantiation of occurrence of transactions

    (b) Its objective is to establish existence, ownership, valuation and disclosure of assets

    (c) The auditor has to form an opinion on different aspects

    (d) All are true

12. Which of the following statements is not true ?

    (a) Valuation of assets is the responsibility of management

    (b) The auditor can rely on a certificate issued by an authorised Value as to the valuation of assets in the balance sheet

    (c) The auditor should value the asset as per generally accepted accounting principles

    (d) Valuation is no part of auditor's duty

13. Which of the following has been matched correctly ?

    (a) Type of asset

    (b) Wasting Asset

    (c) Outstanding asset

    (d) Floating asset

14. An auditor is verifying valuation of building which has been self-constructed by the client. Which of the following documents is least relevant to the auditor for verification purposes ?

    (a) Bill of contractor

    (b) Certificates of engineer and architect

    (c) Loan agreement with the bank which financed construction

    (d) Parent deed

15. Which of the following assets is least likely to be subjected to lieu ?

    (e) Freehold land

    (f) Plant and machinery

    (g) Leasehold property

    (h) Motor vehicles

16. An analysis of fixed assets account has revealed possibility of unrecorded sale of plant and machinery. Which of the following audit procedures may be adopted to discover it ?

    (a) Examination of property tax files

    (b) Inquiry of plant manager

    (c) Examination of debits to accumulated depreciation

    (d) All of the above

17. The auditor has noticed existence of recurring losses on sales of fixed assets. This indicates

    (a) Depreciation charges are insufficient

    (b) Policy of sale or disposal of fixed assets needs to be reviewed

    (c) The sale of assets have not been properly authorised

    (d) Accounting errors

18. Which of the following financial statement assertions are addressed by testing the cut off for plant asset addition ?

    (a) Existence and ownership

    (b) Valuation and disclosure

    (c) Possession and ownership

    (d) Completeness and valuation

19. The auditor while verifying prepaid insurance has concluded that there is inadequate insurance of building.He should --

    (a) Modify his audit report

    (b) Insist it should be disclosed in the notes to financial statements

    (c) Write it in letter of weakness

    (d) Both (b) and (c)

20. While verifying intangible assets, an auditor would recomputed amortisation charges and determine whether amortisation period is reasonable. The auditor tries to establish …… by doing it

(a) Valuation

(b) Existence

(c) Disclosure

(d) Possession

21. When auditing prepaid insurance, an auditor discovers that the insurance policy loan on building is not available for inspection. This may indicate --

(a) a. No. insurance has been undertaken for building

(b) Linen on building

(c) Insurance premium has not been paid

(d) Insurance premium paid but not recorded.

22. Equity shares of XY Ltd. Held by ABC Ltd. Are in the custody of Stock Holding Corporation of India Limited. The auditor may verify this investment by —

(a) Reviewing last year's Working papers.

(b) Obtaining a certificate from a responsible official of the ABC Ltd. C.

(c) Obtaining a certificate from SHCIL.

(d) Obtaining a certificate from SY Ltd.

23. Which of the following controls would ensure that securities are not lost, stolen or diverted ?

(a) Which of the following controls would ensure that securities

(b) Maintain files of authorised signatures

(c) Segregate investment approval from accounting and from custody of securities

(d) All of the above.

24. Which of the following is not a proper third party to hold investments on behalf of the clients ?

(a) Regional level custodian

(b) National level custodian

(c) India trills - National level stock broking firm AEZ Securities Ltd.

(d) A stock broking firm

25. Which of the following would give the assurance that debtors mentioned on the date of balance sheet actually exist ?

    (a) Sending debtors' confirmation letters

    (b) Reviewing subsequent collection

    (c) verify debtors against sales document

    (d) Both (a) and (b)

26. Analytical procedures are least likely to be use in the audit of --

    (a) Cash balances

    (b) Investments

    (c) Bills receivables

    (d) Debtors

27. Which of the following statements is not true with regarded to teeming and lading ?

    (a) It results in the deliberate misappropriation of cash receipts.

    (b) It is associated with cash receipts.

    (c) If same individual maintains cash receipts and cash payments teeming and lading is likely to exist

    (d) To conceal the shortage, the defraud, usually, tries to keep bank and book amounts in daily agreement so that a bank reconciliation will not detect the irregularity.

28. The balance of cash in often between one to five per cent of total assets. Tick the most appropriate statement with regard to verification of cash in context of this.

    (a) Cash in always material as materiality is a qualitative concept

    (b) No audit of cash is needs when, in auditor's opinion, cash is immaterial.

    (c) Materiality is a relative concept

    (d) The cash balance need only be audited if the balance is in overdraft Cash is to be verified if control risk is assessed as high

29. When counting cash on hand the auditor should --

    (a) Ensure presence of somebody from management

    (b) Obtain a receipt from custodian as to its return

    (c) Ensure postage and revenue stamps are not counted in physical count

    (d) Temporary advances to employees are counted to calculate balance of cash in hand

30. What should an auditor do to ensure that stock is stated at the lower of cost and net realizable value ?

    (a) Compare the cost data of the present year to previous year

    (b) Select a sample of stock items held at year-end and compare their value with that for subsequent sales of similar items

    (c) Ensure slow-moving, obsolete and damaged stock are valued at cost and shown separately

    (d) Select a sample of purchases made during the year and check the associated purchase invoices to ensure they have been recorded at cost

31. Which of the following has not been matched correctly Analytical procedure-

    (a) Compare inventory turnover of current year to prior years

    (b) Compare gross profit ratio in for current year to prior years

    (c) Compare reported level of finished goods stock of current year to prior years

    (d) Compare number of days' sales in inventory of the current year with that of prior years

32. The auditor wants to search for unrecorded liabilities. Which of the audit procedures is he likely to adopt ?

    (a) Examination of purchase invoices and statements received from creditors both immediately prior to and following year-end.

    (b) Compare ratio of accounts payable to purchases of the current year with prior years.

    (c) Evaluate internal controls for their effectiveness.

    (d) All of the above.

33. Auditor's confirmation of accounts payable balances at the balance sheet date may not be required because

    (a) Purchases are recorded on the basis of external evidence

    (b) Cut-off procedures give the desired result

    (c) Payments can be traced in the bank statement.

    (d) Creditors do not reply.

34. For verification of liabilities which of the following is the most important object ?
    (a) Existence
    (b) Completeness
    (c) Valuation
    (d) Disclosure
35. Unearned portion of income not relating to the period under audit should be shown as --
    (a) Current asset
    (b) Current liability
    (c) Long-term asset
    (d) Long-term investment.
36. The primary objective of audit of provision is to establish their --
    (a) Adequacy
    (b) Completeness
    (c) Occurrence
    (d) Authorisation
37. When would a provision for contingent loss be provided in financial statements ?
    (a) In case of possibility of loss
    (b) In case board of directors pass a resolution
    (c) In case of probability of loss
    (d) Any of the above.

CHAPTER 7

THE COMPANY AUDIT – I

Learning Objectives

After studying this chapter, you will be able to -

- Understand qualification and disqualification of an auditor.
- Know the procedures of appointment, reappointment, filling up of the casual vacancies and removal of auditor.
- Understand powers and duties of auditor.
- Prepare the audit report and branch office accounts, joint audit, special audit, cost audit and statutory audit.

Sections 224 to 233 of the Companies Act, 1956 (hereinafter referred to as the Act unless otherwise mentioned) deal with provisions relating to audit of companies. Therefore, it is quite important to understand these provisions very carefully. You may also study sections 209 to 223 relating to "Accounts" of companies for better understanding of the subject. The provisions relating to 'audit' broadly deal with who can be appointed as an auditor under the Act, *i.e.,* qualifications and disqualifications, the manner of appointment and removal of an auditor and rights and duties of an auditor. A scheme of the provisions of the Act relating to audit is given below for quick reference:

SECTIONS

224. Appointment and remuneration of auditors

224A Auditor not to be appointed except with the approval of the company by special resolution in certain cases.

225 Provisions as to resolutions for appointing or removing auditors

226. Qualifications and disqualifications of auditors

227. Powers and duties of auditors

228. Audit of accounts of branch office of company

229. Signature of audit report, etc.

230. Reading and inspection of auditor's report

231. Right of auditor to attend general meeting

232. Penalty for non-compliance with sections 225 to 231

233. Penalty for non-compliance by auditor with sections 227 and 229

233A. Power of Central Government to direct special audit in certain cases

233B. Audit of cost accounts in certain cases

7.1 QUALIFICATIONS AND DISQUALIFICATIONS OF AN AUDITOR

They are governed by section 226 of the Act. The main provisions are stated below :

(1) A person shall not be qualified for appointment as an auditor of a company (public or private) unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949; provided that a firm whereof all the partners practising in India are qualified for appointment, as aforesaid, may be appointed by its firm name to be the auditors of a company in which case any partner so practising may act in the name of the firm [Section 226(1)]; and

(2) Notwithstanding anything contained in sub-section (1) but subject to the Rules made under clause (*b*) of sub-section (2), the holder of certificate granted under the law in force entitling him to act as an auditor of companies in the whole or in any part of Part B States, immediately before the commencement of the Part B States (Laws), 1951 is entitled to act as an auditor of companies registered anywhere in India.

Note: *It was only a transitional provision and is not relevant as on date.*

As per the provisions of the Act, the chartered accountants have exclusive authority to act as the auditors. A chartered accountant either in his individual capacity may act as the auditor or a firm may also act as an auditor provided all partners in the said firm are chartered accountants within the meaning of the Chartered Accountants Act, 1949.

(3) Under sub-section (3) of section 226, the following persons are not qualified for appointment as auditors of a company :

(a) a body corporate;

(b) an officer or an employee of the company;

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

(d) a person who is indebted to the company for more than Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for more than Rs. 1000; and

(e) a person holding any security of that company.

Explanation - For the purposes of this section, "security" means an instrument which carries voting rights.

(4) It is further laid down in sub-section (4) of section 226 that a person is not eligible for appointment as auditor of any company, if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.

(5) Sub-section (5) of section 226 provides that if an auditor, after his appointment, becomes subject to any of the disqualification specified in sub-sections (3) and (4), *i.e.,* in respect of matters described in paragraphs (3) and (4) above, he shall be deemed to have automatically vacated his office.

Students may note that these provisions have been introduced with the objective that the accounts of companies shall be audited only by persons of proven standing who will be under the discipline of a professional body, *viz.,* the Institute of Chartered Accountants of India. Only a person holding a certificate of practice issued by it is qualified for appointment as auditor. The provisions relating to disqualifications aim to prohibit certain financial or personal relationships so as to ensure that an auditor appears to be independent to the world at large. The main purpose of disqualifying a body corporate to act as an auditor is perhaps on the grounds that the accountancy profession is rendering services to society which are of personal nature. The effect of corporate form of entity would be that the limited liability shall be detrimental in the interests of the profession. To ensure that he would be independent in his attitude and judgment, it has also been provided that the auditor shall not be connected or associated with directors or any officer of the company either as a partner or an employee. With the inclusion of clause (e) in sub-section (3) of section 226, the legislator had introduced a very stringent requirement whereby an auditor shall not be able to hold even a single share or any other kind of security. A firm would also be disqualified to be appointed as an auditor even if one partner is disqualified under this clause.

It is also a requirement that when a Chartered Accountant, being a relative of person(s) having substantial interest in the company or in any business, expresses any opinion on financial statements of the company, or of the business, he should disclose his interest while making the report. If this disclosure is not made, it would amount to "misconduct"

under the Chartered Accountants Act, 1949. 'Relative' for this purpose means a relative within the meaning of section 6 of the Act. Similarly, the expression 'substantial interest' shall have the same meaning assigned thereto under *Explanation 3* to section 13 of the Income-tax Act, 1961. Students may also note carefully that there is no bar under the Act to prohibit an auditor of a company from rendering other services in the capacity of a consultant. Rather an auditor because of his vast knowledge and familiarity about the client's affairs is perhaps the best person to render advisory services. In this case, attention is also invited to Part II of Schedule VI to Act where auditor's remuneration has to be shown under different heads. Further, a person is also not disqualified for appointment as auditor of a company if his relatives or employees act as a director, secretary, or otherwise as an officer or employee of the company. But the Central Government's permission may have to be obtained under section 314 of the Act. The Council of the Institute, however, recently issued a notification wherein it imposed a cap on audit fees to be received from audit *vis-à-vis* other services.

7.2 APPOINTMENT OF AUDITOR

7.2.1 Appointment by shareholders

Sub-section (1) of section 224 of the Act empowers the shareholders to appoint auditor at each annual general meeting. In fact, this sub-section makes it obligatory that every company irrespective of its nature, *i.e.,* whether a public or private or a company with unlimited liability, limited company; non-profit company or profit oriented company; or irrespective of its size shall appoint auditors. The usage of word "each" is also quite significant since it amounts to passing a resolution at each AGM to appoint an auditor meaning thereby that a retiring auditor would not be reappointed automatically.

Appointment in a general meeting of the company means appointment by the shareholders of the company. Upon an auditor being appointed in the annual general meeting, the company is to give intimation thereof to the concerned auditor within seven days of the appointment. The auditor, in his turn, on receipt of the intimation from the company about his appointment, is required to send a written communication to the concerned Registrar of Companies within 30 days of the receipt of the intimation stating whether he has accepted or declined the appointment. The auditor has to communicate his acceptance or refusal in writing and must be in Form No.23B prescribed under the Act. It may be noted that this requirement of intimation and communication in writing about acceptance or refusal to accept is restricted to appointment made in the annual general meeting only.

It may also be noted that sub-section (1) makes it amply clear that an auditor shall hold appointment from the conclusion of one annual general meeting to the conclusion of the next annual general meeting. Therefore, an auditor's tenure of appointment has been clearly spelt out in this section.

7.2.2 Appointment of the First Auditor

The first auditor of a company can be appointed by the Board of Directors within one month of the date of registration of the company to hold office till the conclusion of the first annual general meeting. If the Board fails to appoint the first auditor, the company in general meeting is empowered to make the appointment. The first auditor or auditors to hold office, until the conclusion of the first annual general meeting, should be appointed by the Board of directors within one month of the date of registration of the company. But the company may, at a general meeting, remove such an auditor or all or any of them and appoint another or others in his or their place, on a nomination being made by any member of the company, notice being given to the members of the company, not less than fourteen days before the date of the meeting.

If the first auditor(s) is not appointed by the directors, within one month of registration, the company in general meeting may appoint the first auditor. The auditor of a company normally is appointed by the shareholders by passing a resolution at the annual general meeting; once appointed, he holds office from the conclusion of that meeting to the conclusion of the next annual general meeting. An auditor once appointed may be re-appointed in the next annual general meeting or a new auditor may be appointed in his place. It is obligatory on the part of a company to annually make such an appointment, as well as to give, within seven days of the appointment, intimation thereof to every auditor so appointed or re-appointed.

The main aspect of this section are as under:

1. The first auditors are generally to be appointed by the Board of Directors by means of a resolution within one month of the date of registration of the company.
2. The auditors so appointed shall hold office until the conclusion of the first annual general meeting.
3. If the Board of Directors fail to appoint the first auditors, the company at a general meeting may do so.
4. The auditors so appointed by the Board of Directors may be removed by the company at a general meeting and which then may appoint any other auditor.

5. An auditor cannot be appointed as first auditor simply because his name has been stated in the Articles of Association.
6. The first auditor need not be sent intimation by the company of their appointment.
7. The first auditors are themselves not required to inform the Registrar of Companies about their acceptance or refusal of such an appointment.
8. It should be noticed that it is merely a general meeting and not necessarily an annual general meeting in which such a removal/appointment is made.

7.2.3 Reappointment of auditor

The Companies Act, 1956 stipulates the office of auditor in a company as a continuing one; therefore, it has laid down that an auditor shall hold office from the conclusion of the annual general meeting in which he is appointed till the conclusion of the next annual general meeting. Excepting cases of appointment of the first auditor, appointment or filling of casual vacancies in the office of the auditor, companies are required to appoint an auditor or auditors in the annual general meeting as a routine feature. A specific resolution is required to re-appoint the auditors. The retiring auditor cannot be deemed to be re-appointed automatically at the annual general meeting. Till a formal resolution is passed, a retiring auditor cannot be said to have been re-appointed as contemplated by the section. It is not correct to say that in the absence of a resolution to the effect that the retiring auditors shall not be re-appointed, the retiring auditors shall stand re-appointed as auditors of the company. This appointment is subject to the following conditions :

(i) The auditor proposed to be appointed or re-appointed must possess the qualification prescribed under section 226.

(ii) The proposed auditor does not suffer from the disqualifications enumerated in sub-sections (3) and (4) of section 226.

(iii) In the case of proposed re-appointment of the retiring auditor, it should be ensured that:

  (a) he has not given to the company notice in writing of his unwillingness to be reappointed;

  (b) no resolution has been passed at the annual general meeting appointing somebodyelse instead of the retiring auditor or providing expressly that the retiring auditor shall not be re-appointed;

  (c) no notice of the intended resolution to appoint some other person or persons in place of the retiring auditor was received by the company that could not be proceeded with due to death, incapacity or disqualification of the other person or persons [Section 224(2)].

(iv) A written certificate has been obtained from the proposed auditor to the effect that the appointment or re-appointment, if made, will be in accordance within the limits specified in sub-section (1B) of section 224.

7.2.4 Filling of a Casual Vacancy

A casual vacancy in the office of the auditor can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. In case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor. The expression 'casual vacancy' has not been defined in the Act. Taking its natural meaning, it stands for a vacancy created by the auditor ceasing to act after he was validly appointed and the appointment was accepted. This may arise due to a variety of reasons which include death, resignation, disqualification, dissolution of the firms of auditors, etc. The provision to require the filling of casual vacancy caused by resignation of the auditor by the general meeting is in consonance with the principle of auditor's independence. The process may bring out facts regarding the auditor's resignation to the notice of, and hence scrutiny by the shareholders. Any abuse of authority or financial impropriety by the management, that might have contributed to the resignation, will be known. If the auditor could be found to be conscientious and honest, the general meeting may even request him to reconsider his decision and take appropriate steps to cure the evils, if any, in the management. The auditor appointed to a casual vacancy shall hold office till the conclusion of the next annual general meeting.

7.2.5 Appointment by the Central Government

Where at an annual general meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. It is the duty of the company to give notice of the fact, that no auditor was appointed in the annual general meeting, to the Central Government within seven days of the annual general meeting. No form has been prescribed under the statute for such matters. In case of any default to give such notice to the Central Government, the company and it's every officer in default shall be punishable with fine that may extend to Rs. 5000.

7.2.6 Appointment of Auditor by Special Resolution

Section 224A of the Act provides for appointment or re-appointment of auditors in certain cases only by special resolution. It should be remembered that normally an auditor can be appointed by an ordinary resolution. However, in terms of section 224A, a company in

which not less than 25% of the subscribed capital is held by : (*i*) a public financial institution or a government company or the Central Government, or any State Government, or (*ii*) 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, (*iii*) a nationalised bank or an insurance company carrying on general insurance business; or (*iv*) any combination of the above categories, shall appoint or re-appoint an auditor in the annual general meeting only by passing a special resolution.

In case the aforesaid company omits or fails to pass a special resolution in the annual general meeting for appointing auditors, it shall be deemed that no auditor or auditors had been appointed and thereupon the Central Government's power to appoint the auditor pursuant to section 224(3) will become operative.

In determining whether the appointment calls for a special resolution or not, the measuring yard stick is the proportion of the subscribed capital held by the various categories mentioned above. If any of them singly or several of them jointly hold 25% of the subscribed capital of the company as on the day of the closing of the register of members before the annual general meeting, the company will be covered by provisions of section 224A and consequently, the appointment of auditor can only be made by passing a special resolution. Government has clarified that for the purposes of section 224A the composition of shareholding shall be of the day of annual general meeting. This will virtually be same in relation to the position available on the day of the closing of the register of members stated above. It should be noted that subscribed capital includes preference share capital also.

7.2.7 Appointment of Auditor of a Government company

A Government company has been defined in section 617 of the Act "as any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government company as thus defined".

In respect of any government company appointment of auditor is governed by the provisions of section 619 of the Act. According to this section, the auditor of a government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. However, the appointment will be subject to the ceiling discussed below under paragraph 7.3.

The aforesaid provisions applicable to the appointment of auditor of government companies also apply to another category of companies, even though they are not government companies as contained in section 619B of the Act. Accordingly, the provisions of section 619 apply to a company in which not less than 51% of the paid-up share capital is held by one or more of the following or any combination thereof:

(a) the Central Government and one or more government companies;

(b) any State Government or Governments and one or more government companies;

(c) the Central Government, one or more State Governments and one or more government companies;

(d) the Central Government and one or more corporations owned or controlled by the Central Government;

(e) the Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;

(f) one or more corporations owned or controlled by the Central Government or the State Government;

(g) more than one government company; the auditor of such a company shall be appointed by the Central Government on the advice of the Comptroller and Auditor General of India.

It should be noticed that the provisions of section 224A which require a special resolution for the appointment of auditor and section 619B have made the acceptance of the position of auditor in a company somewhat difficult. Before acceptance of the appointment given by any company, an auditor should specifically satisfy himself that the company is not covered by either section 224A or section 619B which require compliance with special procedure; otherwise he may find the appointment to be a nullity.

7.2.8 Auditor Appointed at an Annual General Meeting Failing to Accept the Appointment

Can the Board of directors be authorised by the general meeting to appoint auditors in the event of auditors appointed at an annual general meeting fail to accept the appointment? For knowing the correct legal procedure that should be followed in such a case, the Research Committee of the Institute had posed the following query to its Counsel :

(1) A company appointed auditors for the current year by a resolution passed in the Annual General Meeting as under :

"Resolved that Shri X (Chartered Accountants) be and is hereby re-appointed as a joint auditor for the current year on an overall remuneration of Rs.....only"

"Resolved further that Shri Y (Chartered Accountants) be and is hereby re-appointed as a joint auditor for the current year on an overall remuneration of Rs. .....only." Further resolved that in the event of both or either of the auditors declining the assignment, the Board may fill up the vacancy at their own discretion".

(2) The Board of directors, subsequently, passed a resolution as under :

"Resolved that in the event of any of the auditors declining to accept the assignment, Shri Z should be appointed as joint auditor".

(3) The last para of the resolution of the general meeting and the resolution itself of the Board of Directors, were intended to meet a contingency of the appointments being declined by any or both of the auditors appointed by the general meeting since the remuneration fixed by the general meeting was less than that proposed by the retiring auditors, and there was a possibility of the appointments being rejected by the auditors on that account.

(4) Y declined to accept the assignment and Z was called upon to intimate his willingness or otherwise to accept the assignment pursuant to the resolution of the Board of Directors. The Counsel's opinion was sought on the following points :

(a) whether the vacancy caused by Y declining to accept the appointment constituted a casual vacancy under sub-section 6(a) of section 224 or one due to resignation of an auditor; and

(b) was the appointment of Z, made by the Board of Directors in place of Y, valid?

The Counsel was of the opinion that the Board of Directors could appoint an auditor only under the circumstances contemplated under sub-section 5 and under sub-section 6(*a*) of section 224. Further that, in the specific case referred to him for opinion, the refusal of Y to accept the appointment as joint auditor did not create a vacancy either casual or by resignation since Y's appointment had not become effective. Further, the appointment of an auditor having been made by the shareholders, sub-section (3) could not be invoked. Thus, Z could only be appointed by shareholders at general meeting.

7.2.9 When Appointment is Made to Fill Up a Vacancy of Resignation of the Previous Auditor

An auditor, before accepting the appointment in place of an auditor who has resigned should verify that the resolution appointing him as the auditor at the general meeting was duly moved and approved by the shareholders. In addition, he should refer to the resignation submitted by the previous auditor and also communicate with him so as to

ascertain: (*i*) the circumstances which led upto his resignation; and (*ii*) whether there exist any circumstances on account of which he should not accept the appointment.

Notes:

(1) Though there is no provision in the Act for an auditor ceasing to hold office on becoming bankrupt or insane, it will not be possible for a person of unsound mind or an undischarged insolvent to hold such office as he will not, under sections 8 and 20 of the Chartered Accountants Act, 1949, have his name on the Register of Chartered Accountants.

(2) In the case of appointment of an auditor to act jointly with an existing auditor, the procedure would be similar to that where the existing auditor is being removed (as discussed hereinafter). In practice, however, compliance with the formalities would not give rise to any difficulties since the existing auditor's consent to the proposal, it is expected, will have been secured in advance.

(3) Although the appointment of an auditor is made annually, it has been generally felt that there should, as far as possible, be continuity of appointment to secure the auditor's independence. It would not be possible, so long as he is not protected against being penalized by removal, for him to make an adverse criticism of the accounts produced by the directors. On this consideration, a provision has been made for his normal re-appointment by the company in a general meeting; also for the casual vacancy, caused by the resignation of an auditor, to be filled by the shareholders.

7.3 CEILING ON NUMBER OF AUDITS

It has been mentioned earlier that before appointment is given to any auditor, the company must obtain a certificate from him to the effect that the appointment, if made, will not result in an excess holding of company audit by the auditor concerned over the limit laid down in section 224(1B).

Section 224(1B) provides that on and from the financial year next following the commencement of the Companies (Amendment) Act, 1974, no company or its Board of Directors shall appoint or re-appoint any person or firm as its auditors if such person or firm is at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies. The Companies (Amendment) Act, 1988 has further specified that no company or its Board of Directors shall appoint or re-appoint any person who is in full employment elsewhere. In the case of a firm of auditors, it has been further provided that 'specified

number of companies' shall be construed as the number of companies specified for every partner of the firm who is not in full time employment elsewhere.*

This limit of 20 company audits is per person. In the case of an audit firm having 3 partners, the overall ceiling will be 3 × 20 = 60 company audits of which not more than 30 should be in companies having paid up capital of Rs. 25 lakhs or more. Sometimes, a chartered accountant is a partner in a number of auditing firms. In such a case, all the firms in which he is partner or proprietor will be together entitled to 20 company audits on his account. Subject to the overall ceiling of company audits, how they allocate the 20 audits between themselves is their affairs.

Explanation II after sub-section (IC) of section 224 further amplifies the manner of identifying the audit units for calculating the specified number. Under this explanation, when an auditor is appointed to audit even a part of a company's accounts, the part will be considered as a unit of audit for the purpose of calculation of the ceiling. Often, now-a-days, one comes across what is known as joint audit - when two or more auditors are appointed to audit the account of a company. Each of the joint auditor is considered a part auditor for the purpose. Any joint audit held by an auditor will be included as one audit unit for the purpose of calculating the ceiling of audits. However, audit of a branch of company is not included in the computation of the ceiling. Similarly, audit of corporations which are not companies and foreign companies are also not to be included. Further, it may be noted that even non-profit companies would be counted for the purpose of ceiling. However, guarantee companies not having share capital, special audit and investigation of companies will not be counted for the purpose.

Students may also note that the Companies (Amendment) Act, 2000 has amended section 224(1B) by adding a proviso that provisions shall not apply to a private company on and after the commencement of the Companies (Amendment) Act, i.e. 13.12.2000. Therefore, with this amendment, while computing the ceiling a number of audits, only audit of public companies would be taken into consideration. In other words, an auditor can accept audit

* Students may note that the intention of government in amending section 224(1B) was to plug the loop hole whereby even a chartered accountant in whole time employment could audit twenty companies if he held the certificate of practice. However, there seems to be drafting error whereby the amended section tends to suggest that the limit of twenty audits is no longer applicable to individual chartered accountants in practice provided may are not in wholetime employment. This anomaly is already under the consideration of the Ministry of Company Affairs. However, in view of the ICAI's Notification, this anomaly has been taken care of because a member of the ICAI is bound by the Notification.

of any number of private companies. This, however, is subject to guidelines of the Institute which provide restriction in respect of private companies as well. The Notification reproduced below:

No.1-CA(7)/53/2001: In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute of Chartered Accountants of India hereby specifies that a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than the "specified number of audit assignments of the companies under Section 224 and /or Section 228 of the Companies Act, 1956.

Provided that in the case of a firm of chartered accountants in practice, the specified number of audit assignments shall be construed as the specified number of audit assignments for every partner of the firm.

Provided further that where any partner of the firm of chartered accountants in practice is also a partner of any other firm or firms of chartered accountants in practice, the number of audit assignments which may be taken for all the firms together in relation to such partner shall not exceed the specified number of audit assignments in the aggregate.

Provided further that where any partner of a firm or firms of chartered accountants in practice accepts one or more audit assignments in his individual capacity, or in the name of his proprietary firm, the total number of such assignment which may be accepted by all firms in relation to such chartered accountant and by him shall not exceed the specified number of audit assignments in the aggregate.

Explanation:

1. for the above purpose, the specified number of audit assignments means-

   (a) in the case of a chartered accountant in practice or a proprietary firm of chartered accountant, thirty audit assignments whether in respect of private companies or other companies.

   (b) in the case of a firm of chartered accountants in practice, thirty audit assignments per partner in the firm, whether in respect of private companies or other companies.

   Provided that out of such specified number of audit assignments, the number of audit assignments of public companies each of which has a paid-up share capital of rupees twenty-five lakhs or more, shall not exceed ten.

2. In computing the specified number of audit assignments.

   (a) the number of such assignments, which he or any partner of his firm has accepted whether singly or in combination with any other chartered accountant in practice or firm of such chartered accountants, shall be taken into account.

   (b) the audit of the head office and branch offices of a company by one chartered accountant or firm of such chartered accountants in practice shall be regarded as one audit assignment.

   (c) the audit of one or more branches of the same company by one chartered accountant in practice or by firm of chartered accountants in practice in which he is a partner shall be construed as one audit assignment only.

   (d) the number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

   (e) a chartered accountant in full time employment elsewhere shall not be taken into account.

3. this notification shall come into force from the date of its publication in the Official Gazette.

4. A chartered accountant in practice as well as firm of chartered accountants in practice shall maintain a record of the audit assignments accepted by him or by the firm of chartered accountants, or by any of the partner of the firm in his individual name or as a partner of any other firm as far as possible, in the prescribed manner.

   (Note: Ceiling on tax audit assignments: The specified number of tax audit assignments that an auditor, as an individual or as a partner of a firm, can accept is 45 numbers. The ceiling limit was increased from 30 to 45 numbers in the year 2007. ICAI has notified that a chartered accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts in a financial year, more than the specified number of tax audit assignments u/s 44AB.)

7.4 AUDITOR'S REMUNERATION

Under section 224(8) of the Act, the remuneration of the auditors of a company is fixed: (1) by the directors when auditors are appointed before the first annual general meeting by the directors or to fill a casual vacancy (other than one caused by the resignation of the auditor); (2) by the Central Government when the appointment is made by the same authority; (3) by the company in general meeting or in such manner as the company in general meeting may determine and (4) in the case of an auditor appointed under section

619 by the Comptroller and Auditor-General of India, shall be fixed by company in general meeting or in such manner as the company in general meeting may determine.

For this purpose, the expression "remuneration" should be deemed to include any sums paid by the company in respect of auditor's expenses.

Students may note that the Act does not require that the remuneration should be fixed at the same meeting of the company at which the appointment is made. It may, therefore, be fixed at a subsequent meeting. Where a retiring auditor is re-appointed, his remuneration, in the absence of any resolution fixing a different remuneration, is considered to be the amount already fixed. Where, in addition to the normal audit, the auditor is also required to undertake the writing up of the books and to prepare annual accounts of the company or Income-tax or secretarial work, he is entitled to receive a remuneration in addition to the fees for audit. The additional remuneration is a matter of arrangement with the Directors. But any remuneration paid as fees, expenses or otherwise for such services must be disclosed in the Profit and Loss Account :

(a) as auditor;

(b) as adviser, or in any other capacity in respect of :

  (i) taxation matters;

  (ii) company law matters;

  (iii) management services; and

(c) in any other manner.

The aforesaid manner of disclosure is required by Part II of Schedule VI to the Act. This has presumably arisen out of the recommendation of the Council of the Institute of Chartered Accountants of India in that regard. The Council recommended a more detailed disclosure to enable the readers of the annual statements of account to have this information more precisely and in greater detail.

7.5 REMOVAL OF AUDITORS

7.5.1 Removal of Auditor before Expiry of Term

As per sub-section (7) of section 224, an auditor may be removed from office before the expiry of his term, by the company in a general meeting, obtaining the prior approval of the Central Government in that behalf except that such approval is not required for the removal of the first auditor appointed by the Directors under the proviso to sub-section

(5) of section 224. This is a very stringent provision to ensure that any auditor who is inconvenient to the management cannot be removed so easily. Such a provisions goes a long way to ensure independence of auditor. Thus, first auditor, appointed by the Board of Directors may be removed by merely passing an ordinary resolution. However, a nomination notice from a member of the company of at least 14 days is required for the appointment of any other person in his place.

7.5.2 After Expiry of Term

Section 225 lays down procedure to remove an auditor after expiry of the term, *i.e.,* conclusion of the next annual general meeting. It requires that for appointing a person other than the retiring auditor or for proposing that the retiring auditor shall not be re-appointed, a special notice (14 days) is required for resolution to be moved at the annual general meeting [section 225(1)]. On receiving such a notice, the company must forthwith send a copy thereof to the retiring auditor [Section 225 (2)]. If the retiring auditor makes a representation in writing, not exceeding a reasonable length, to the company and requests the company to notify such representation to the members, the company shall (unless the representation is received too late), in any notice of the resolution given to the members, state the fact of the representation having been made and send a copy of the representation to every member to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company. If a copy of the representation is not sent, as aforesaid, because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation be read out at the meeting.

The auditor's right to have copies of the representation sent out or read out at the meeting is hedged by the provision that if the Central Government is satisfied, on an application by company or any other aggrieved person, that the right is being abused to secure needless publicity for a defamatory matter, the Central Government may order that the representation may not be circularised or read out; also that the company's costs on such an application should be paid in whole or in part by the auditor even though he is not a party to the application [Section 225(3)].

The foregoing provisions are equally applicable to a resolution to remove the first auditors, or any of them appointed by the directors under section 224(5), removal of any auditors before the expiry of their term under section 224(7) except that special notice is not required to be sent in such cases as required under sub-section (1) of section 225.

Students may note the following :

(1) Accepting a position as an auditor, previously held by another Chartered Accountant, without first communicating with him in writing, is a breach of professional etiquette and is one of the acts of commission which are specified under section 22 of Chartered Accountants Act, 1949. Failure to do so would constitute a misconduct leading to an enquiry into his conduct by the Council of the Institute and, if proved may result in the person declared unfit to continue to be a member of the institute.

It must be remembered that professional courtesy alone is not the major reason for requiring a member to communicate with the existing auditor, who is a member of the Institute. The underlying objective that the member may have an opportunity to know the reasons for the change, in order to be able to safeguard his own interest, the legitimate interest of the public and the independence of the existing auditors. It is not intended, in any way, to prevent or obstruct the change. When making the enquiry from the retiring auditor, the one proposed to be appointed, should primarily find out whether there is any professional reason why he should not accept the appointment.

The Council of the Institute is of the opinion that it would be a healthy tradition, if the practice of communication to the member who has done the work previously is followed in every case where a Chartered Accountant is required to give certificate on a verification of books of account, as well as in the case where he is appointed as a Liquidator, Trustee or Receiver and his predecessor is a Chartered Accountant.

(2) A Chartered Accountant must also ascertain before accepting an appointment as auditor of a company, whether requirements of sections 224 and 225 of the Act, in respect of the appointment of auditors, have been duly complied with. Failure to do this will evoke disciplinary action similar to that mentioned in the foregoing paragraph.

7.6 POWERS OF AUDITORS

(a) *Right of access to books, etc.* - The auditor of a company, at all times, has the right of access to the books and accounts and voucher of the company whether kept at the head office or elsewhere and he is entitled to obtain from the officers of the company such information and explanations as he thinks necessary, for the performance of his duties as auditor [Section 227(1)].

It may be noted that according to section 2(30) of the Act, the term 'officer' includes any director, manager or secretary or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors are accustomed to act. The expression, "But save in sections 477, 478, 539, 543, 545, 621, 625 and 633,

the term 'officer' will not include an auditor", has been dropped by the Companies (Amendment) Act, 2000. With this amendment, the definition of "officer" now does not include auditor for certain provisions of the Act.

The phrase 'books, accounts and vouchers' includes all books which have any bearing, or are likely to have any bearing on the accounts, whether these be the usual financial books or the statutory or statistical books; memoranda books, *e.g.,* stock books, costing records and the like may also be inspected by the auditor. Similarly the term 'voucher' includes all or any of the correspondence which may in any way serve to vouch for the accuracy of the accounts. Thus, the right of access is not restricted to books of account alone and it is for the auditor to determine what record or document is necessary for the purpose of the audit. Further, the right of access is not limited to those books and records maintained at the registered or head office so that in the case of a company with branches, the right also extends to the branch records, if the auditor considers it necessary to have access thereto [Section 228(2)]. If in his opinion, proper returns adequate for the purpose of his audit have not been received from branches, not visited by the auditor, this must be stated in his report [Section 227(2)(*bb*)].

(b) *Right to require information and explanation from officers* - This right of the auditor to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor is a wide and important power. In the absence of such power, the auditor would not be able to obtain details of amount collected by the directors, etc. from any other company, firm or person as well as of any benefits in kind derived by the directors from the company, which may not be known from an examination of the books. It is for the auditor to decide the matters in respect of which information and explanations are required by him. When the auditor is not provided the information required by him or is denied access to books, etc., his only remedy would be to report to the members that he could not obtain all the information and explanations he had required or considered necessary for the performance of his duties as auditors.

(c) *Right to attend general meeting* - The auditors of a company are entitled to attend any general meeting of the company (the right is not restricted to those at which the accounts audited by them are to be discussed); also to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors (Section 231).

The right of the auditor is to attend any general meeting and to be heard there is only permissive. It is not his duty to attend or to take part in the discussion, further such a right extends only to meeting of the members and not to the meeting of directors. As a rule, it is not necessary for the auditor to exercise his right save in exceptional

circumstance, *e.g.,* where he has reason to believe that the directors are concealing deliberately a serious state of affairs from the shareholders or are likely to misinterpret to them some remarks in the audit report. Likewise, it may be advisable for the auditor to attend the meeting with a view to bring to the notice of the shareholders any matter which has come to his knowledge subsequent to his signing the report and if it had been known to him at the time of writing his audit report, he would have drawn up the report differently; or where the accounts have been altered after the report was appended to the accounts. But it should be borne in mind that the auditor cannot escape responsibility for any omission in his report or any inaccuracy in the accounts merely by making an oral statement or giving explanation to members at the annual general meeting. His audit report by itself should be clear, unambiguous and complete.

7.7 DUTIES OF AUDITORS

Sub-sections (1A), (2), (3), (4) and (4A) of the Companies Act, 1956 specifies the duties of an auditor of a company in a quite comprehensive manner. It is noteworthy that scope of duties of an auditor has generally been extending over all these years.

The Companies (Amendment) Act of 1965 introduced two sub-sections (1A) and (4A) in section 227 of the Act; the sub-sections are reproduced below :

"(1A) Without prejudice to the provisions of sub-section (1), the auditor shall enquire:

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

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

(c) where the company is not an investment company within the meaning of 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;

(d) whether loans and advances made by the company have been shown as deposits;

(e) whether personal expenses have been charged to revenue account;

(f) where 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."

(4A) "The Central Government may, by general or special order, direct that, in the case of such class or description of companies as may be specified in the order, that auditor's report shall also include a statement on such matters as may be specified therein :

Provided that before making any such order, the Central Government may consult the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 in regard to the class or description of companies and other ancillary matters proposed to be specified therein unless the Government decides that consultation is not necessary or expedient in the circumstances of the case."

It may be noted that sub-section (1A) is independent both of sub-section (1) which narrates the powers of auditors, and of sub-sections (2) and (3) which states the function and duties of the auditors. It is merely a directive to the auditor to make certain specific enquiries.

In the circumstances, it would be presumed that the legislature by its introduction did not intend to extend the scope of audit report or its form generally. This view is strengthened by the introduction of sub-section (4A). It empowers the Central Government to extend the scope of the audit report in respect of a particular class or description of companies by requiring a statement on such matters as may be specified by the Central Government by a general or special order to be included there.

The opinion of the Research Committee of the Institute of Chartered Accountants of India on section 227(1A) is reproduced below :

"The auditor is not required to report on the matters specified in sub-section (1A) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the content of the Auditor's Report will remain exactly the same as the auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our opinion, it is in this light that the auditor has to consider his duties under section 227(1A)."

Therefore, it could be said that the effect of the introduction of sub-section (1A) is that the auditor should make a report to the members in case he finds answer to any of these matters in adverse. But he has to enquire into all the matters specified in the Order and report thereon.

7.7.1 Scope of Audit Report Under Section 227

Sub-sections (2) and (3) of section 227 provide that it is the duty of the auditor to report to the members of the company on the accounts examined by him and on every balance sheet and profit and loss account and every other document declared by the Act to be part of, or annexed to, the balance sheet and the profit and loss account, laid before the company in general meeting during the tenure of his office; also that the report shall confirm the position, envisaged in the undermentioned manner in which the requirements are to be met.

Sub-section (2) specifically requires that the auditor should report whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Companies Act, 1956, in the manner so required and that the balance sheet gives a true and fair view of the company's affairs at the end of financial year and the profit and loss account gives a true and fair view of the profit or loss for the financial year.

Sub-section (3) requires that the auditor shall report on the following matters :

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

The significance of such a requirement is that the auditor must obtain due satisfaction about the scope of work carried out by him and affirm that in the discharge of his duties he has maintained professional standards of diligence and care.

It should, however, be noted that in the matter of examination of evidence as regards the state of affairs of the company, his duty is limited only to the verification of the evidence that is made available to him in the ordinary course of audit or that which he would call upon to examine on a doubt having arisen that there is something amiss. Suppose, the interest of a director in a transaction, entered into by the company has not been disclosed in the record maintained by the company, as required by section 301 of the Act or the Property Register has not been intentionally produced to prevent detection of the items of plant and machinery that have been given away on loan to a director. In either case, the auditor would not be responsible for failure to track down the frauds, provided during the course of his examination he had asked for the Contract and Property Registers, but the first was incomplete and the existence of the second was denied : provided also that there did not exist any circumstances to arouse his suspicion that some information had been held back deliberately and he had duly reported the violation of the legal requirements.

Justice Lindley in his famous judgment, in the London and General Bank case, propounded this view. The relevant passage from the judgment is quoted below :

"An auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations. He is not an insurer: he does not guarantee that the books do correctly show the true position of the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company, if he did, he would be responsible for an error on his part, even if he were himself deceived without any want of reasonable care on his part say, by the fraudulent concealment of a book from him."

Lopes L. J., held in his judgment in the case of *Kingston Cotton Mills* that auditors must not be made liable for not tracking out ingeniously and carefully laid scheme of fraud when there is nothing to arouse their suspicion and when those frauds have been perpetrated by the tried servants of the company and have been undetected for years by the directors.

Thus, for the collection of information, the auditor is entitled to rely upon trusted servants of the company; he can accept representations made by them either orally or in writing, provided reasonable care is taken to ensure that the data or information furnished are true and could be trusted to have been prepared in the course of the working of the company. If, however, there is any circumstances that should arouse suspicion, it would be the auditor's duty to probe it to the bottom. So long as there is no such suspicion, he is only expected to exercise normal caution and care.

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

The proper term 'books of account' is defined indirectly under sub-section (1) of section 209 wherein it is stated that a company shall not be deemed to have kept proper books of account in respect of matters specified in sub-sections (1) and (2) of section 209, if there are not kept such books as are necessary to give a true and fair view of the state of affairs of the company or branch office, as the case may be, and to explain its transactions. The Companies (Amendment) Act, 1988 further requires that the proper books of account shall not be deemed to be kept if such books are not kept on accrual basis and according to the double entry system of accounting.

Further, in section 541(2), it is provided that a company that is being wound up shall be deemed not to have maintained proper books of account if it had not kept:

(i) such books of account as are necessary to exhibit and explain the transactions and financial position of the business of the company including books containing entries made from day to day in sufficient detail of all cash received and all cash paid; and

(ii) where the business of the company has involved dealing in goods, statement of annual stock-taking and (except in the case of goods sold by way of ordinary retail trade) of all goods sold and purchased, showing particulars of goods and those of buyers and sellers in sufficient detail to enable those goods and those buyers and sellers to be identified.

In the circumstances, proper books of account as required by law are those which contain a record of all the transactions specified both in section 209 and section 541(2) in a manner that they present a true and fair view of the state of affairs of the financial position and profitability of the company.

The cost records prescribed under section 209(1)(*d*) also from part of books of account required to be maintained under law.

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

The work of an auditor culminates in the verification of statements of account. It is apparent that the duty, in this regard, would not be properly discharged if he fails to verify them on making a reference to the books of account before proceeding to make a report thereon. When the auditor reports that proper books of account have been kept and the accounts are in agreement therewith, he confirms that he has discharged the specific duty in this regard imposed on him by the law. If proper books of account have not been kept and if there is a discrepancy in the statements of account and the entries as they appear in the books, he should refer to such a position in his report.

(bb) 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 section 228(3)(c) and how he has dealt with the same in preparing the auditor's report.

The Research Committee of the Institute has obtained the views of the Counsel on this matter which are reproduced below :

"Having regard to the scheme of sub-section (2), it is clear that though the company in general meeting appoints a branch auditor, the company's auditor still has a certain measure of responsibility in respect of the accounts and papers of the branch. This is shown by the fact that he has a right to visit the branch and has access to the papers and documents of the branch. He must discharge this responsibility by looking into the branch auditor's report and satisfying himself that, having regard to the report and what he has

seen of the branch and documents of the branch, affairs of the branch are in order. It is clear that it would not be enough for him to use in respect of the branch the formula "as he considers necessary" in his report. He is in substance in overall supervision as the company's auditor and in his capacity he has to make disclosure of anything in regard to the branch which he thinks is not in order and which has come to his notice."

(d) *Whether in his opinion, the balance sheet and the profit and loss account comply with the accounting standards referred to in sub-section (3c) of section 211 of the Companies Act, 1956.*

(e) in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company. This clause requires the auditor to highlight in thick type or in italics the observation or comments which have any adverse effect on the functioning of the company. It may be noted that neither auditor's observations nor comments have any adverse effect on the functioning of the company. Instead, those observation or comments are about matters which may have an adverse effect on the functioning of the company. The auditor now have to evaluate his qualifications or adverse comments to make judgement as to which of them deal with matters that have an adverse effect on the functioning of the company within the overall context of audit of financial statement of the company.

(f) *whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274."*

Clause (f) is required to be read with the provisions relating stated in section 274 (1)(g). Accordingly, the auditor may ensure that certificates are taken from each director are taken on record by the Board to the effect that a director who happens to be on the Board of other companies are not hit by section 274 (1)(g).

The Companies (Second Amendment) Act, 2002 has added Clause (g) in section 227(3), whereby the auditor's report shall have to state whether the cess payable u/s 441A has been paid and if not, the details of the amount of cess not so paid. Section 441A provides for levy and collection of cess on turnover or gross receipt of companies.

Section 211(3A) provides that it is the responsibility of the company to ensure that every profit and loss account and balance sheet of the company shall comply with the accounting standards. In case a company fails to comply with accounting standards, such companies shall disclose in its profit and loss account and balance sheet the deviation from accounting standards, the reasons for such deviation, and the financial effect, if any, arising due to such deviation. Under this sub-clause, a duty has been imposed on auditor to see whether in his opinion, the profit and loss account and balance sheet complied with the accounting standards.

Special requirement in regard to banking, insurance and electricity supply companies - The auditor of a banking company is required by section 30(3) of the Banking Regulation Act also to state the following additional matters viz., (*a*) whether or not the information and explanations required by him have been found to be satisfactory; (*b*) whether or not transactions of the company fall within the powers of a banking company; (*c*) whether or not the returns received from the branch offices of the company have been found adequate for the purposes of his audit; (*d*) whether the profit and loss account shows a true balance of profit and loss for the period covered by such account; and (*e*) any other matter which he considers should be brought home to the shareholders of the company.

Likewise there are special provisions contained in the Insurance Act, 1938 and the Electricity (Supply) Act, 1948 specifying matters on which the auditor should make a report. Similar provisions also are contained in certain other Acts, *e.g.*, Societies Registration Act, 1860. On a consideration of sub-sections (3), (4) and (5) of section 211, a banking, insurance, electricity supply and other companies governed by the special Acts as well as those which have been specially exempted by the Central Government from making a disclosure of certain matters or from complying with certain requirements with regard to the balance sheet and profit and loss account, are exempt from drawing up their balance sheet in the form contained in Schedule VI to the Act and from furnishing particulars of income and expenditure specified in Part II of the Schedule.

The statements of account of the company cannot be deemed to have been improperly drawn up or as not disclosing a true and fair view of the state of affairs of the company merely because they only disclose matters which require disclosure under the special Acts under which they are drawn up or they do not disclose any matter which does not require disclosure by virtue of provisions contained is Schedule VI to the Companies Act or any matter which does not have to be disclosed by virtue of notification issued under sub-section (3) or an order issued under sub-section (4) of section 211. It is thus clear that in the statement of account of a company drawn up under the special Acts, only the information requiring disclosure thereunder needs to be disclosed.

7.7.2 General considerations

The statutory duties of the auditor cannot be limited in any way either by the Articles or by the directors or members but a company may extend them by passing a resolution at the general meeting or making a provision in the articles. [*Newton* v. *Birmingham Small Arms Co. Ltd.* [1875].

An auditor is expected to determine the scope of his duties on a consideration of the nature of business carried on by the concern, provisions of the law that govern the organisation and the system of internal control in operation. Under the Companies Act, sub-sections (1A), (2), (3) (4) and (4A) lay down scope of auditor's duties. However, on taking into account the legal decisions in the cases which so far have been taken to courts, his duties and responsibilities can be summarised as follows :

(i) *To verify that the statements of account are drawn up on the basis of the books of the business* : The auditor is not responsible for failure to disclose the affairs of the company kept out of the books and concealed from him which could not be known in the ordinary course of exercise of reasonable care and diligence. However, it is his duty to check the books for finding out that the position, as shown by the books of account, is true and substantially correct.

(ii) *To verify that the statements of account drawn up on the basis of the books exhibit a true and fair state of affairs of the business* : The duty of the auditor is not limited to mere verification of the arithmetical accuracy of the statements of account. He must find out that these are substantially correct, having regard to provisions in the Articles and the statute governing the business of the organisation under which it is being carried on.

(iii) *To confirm that the management has not exceeded the financial administrative powers vested in it by the Articles or by any specific resolution of the shareholders recorded at a general meeting*

(iv) *To investigate matters in regard to which his suspicion is aroused as to the result of a certain action on the part of the servants of the company* - He is, however, not required to start an audit with a suspicion or to prove in the manner of trying to detect a fraud or an irregularity unless some information has reached him which excites his suspicion or should arouse suspicion in a professional man of reasonable competence. This is because his duty is verification and not primarily detection of fraud.

(v) *To perform his duties by exercising reasonable skill and care* - For the verification of matters which are not capable of direct verification, he can rely on what he believes to be honest statements of the management. He must, however, review the verification of assets by the company and not rely merely on the statement made by the persons appointed by the company.

Reporting on matters contained in the Directors' Report - The duty of any auditor for making a report on the statement of account also extends to matters reported upon by the directors to the shareholders in so far as information which is required to be given by the Act in the statements of account or can be given in a statement annexed to the accounts, are contained in the report of directors (Provisio to Section 222). For instance, the opinion

of the Board of Directors as regards current assets, loans and advances, when contained in the directors report, must be considered by the auditor.

7.8 AUDIT REPORT

The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. This review and assessment involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework applicable to the entity under audit. It is also necessary to consider whether the financial statements comply with the relevant statutory requirements.

The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.

7.8.1 Basic Elements of the Auditor's Report

The auditor's report includes the following basic elements, ordinarily, in the following layout:

(a) Title;

(b) Addressee;

(c) Opening or introductory paragraph

  (i) identification of the financial statements audited;

  (ii) a statement of the responsibility of the entity's management and the responsibility of the auditor;

(d) Scope paragraph (describing the nature of an audit)

  (i) a reference to the auditing standards generally accepted in India;

  (ii) a description of the work performed by the auditor;

(e) Opinion paragraph containing

  (i) a reference to the financial reporting framework used to prepare the financial statements; and

  (ii) an expression of opinion on the financial statements;

(f) Date of the report;

(g) Place of signature; and

(h) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding of the auditor's report and to identify unusual circumstances when they occur.

A statute governing the entity or a regulator may require the auditor to include certain matters in the audit report or prescribe the form in which the auditor should issue his report. In such a case, the auditor should incorporate in his audit report, the matters specified by the statute or regulator and/or report in the form prescribed by them.

(a) **Title:** The auditor's report should have an appropriate title. It may be appropriate to use the term "Auditor's Report" in the title to distinguish the auditor's report from reports that might be issued by others, such as by the officers of the entity, the board of directors, or from the reports of others.

(b) **Addressee:** The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations. Ordinarily, the auditor's report is addressed to the authority appointing the auditor.

(c) **Opening or Introductory Paragraph:** The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements. The report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

An illustration of these matters in an opening (introductory) paragraph is:

> "We have audited the attached Balance Sheet of ..... (Name of the entity) as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit."

(d) **Scope Paragraph:** The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with auditing standards generally accepted in India. The reader needs this as an assurance that the audit has been carried out in accordance with established standards. The Auditing and Assurance Standards issued by the Institute of Chartered Accountants of India establish the auditing standards generally accepted in India.

The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.

The auditor's report should describe the audit as including:

(a) examining, on a test basis, evidence to support the amounts and disclosures in financial statements;

(b) assessing the accounting principles used in the preparation of the financial statements;

(c) assessing the significant estimates made by management in the preparation of the financial statements; and

(d) evaluating the overall financial statement presentation.

The report should include a statement by the auditor that the audit provides a reasonable basis for his opinion.

An illustration of these matters in a scope paragraph is:

> "We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion."

(e) **Opinion Paragraph:** The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements and state the auditor's opinion as to whether the financial statements give a true and fair view in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with the statutory requirements. The term used to express the auditor's opinion, "give a true and fair view", indicates, amongst other things, that the auditor considers only those matters that are material to the financial statements.

An illustration of these matters in an opinion paragraph is:

> "In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:
>
> (a) in the case of the Balance Sheet, of the state of affairs of the ……. (name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date."

(f) **Date of Report:** The date of an auditor's report on the financial statements is the date on which the auditor signs the report expressing an opinion on the financial statements. The date of report informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

(g) **Place of Signature:** The report should name specific location, which is ordinarily the city where the audit report is signed.

(h) **Auditor's Signature:** The report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report should be signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report should also mention the membership number assigned by the Institute of Chartered Accountants of India.

7.8.2 Format of Audit Report

The following is an illustration of a complete auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

"**AUDITOR'S REPORT**

(Appropriate Addressee)

We have audited the attached Balance Sheet of ..... *(Name of the entity)* as at 31st March 2XXX and also the Profit and Loss Account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial



statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and to the best of our information and according to the explanations given to us, the financial statements give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the Balance Sheet, of the state of affairs of ……. (Name of the entity) as at 31st March 2XXX; and

(b) in the case of the Profit and Loss Account, of the profit/loss for the year ended on that date.

For ABC and Co.,
Chartered Accountants
Auditor's Signature
(Name of Member signing the Audit Report)
(Designation)
(Membership Number)

Place of Signature:
Date:

7.8.3 Companies (Auditor's Report) Order, 2003

The Central Government, in exercise of the powers conferred, under sub-section (4A) of section 227 of the Companies Act, 1956 (hereinafter referred to as "the Act"), issued the Companies (Auditor's Report) Order, 2003, (CARO, 2003) vide Notification No. G.S.R. 480(E) dated June 12, 2003. CARO, 2003 contained certain matters on which the auditors of companies (except of those categories of companies which are specifically exempted under CARO, 2003) have to make a statement in their audit report. The Central Government vide Notification No.GSR.766(E) dated November 25, 2004 amended the said Order and issued the Companies (Auditor's Report) (Amendment) Order, 2004. The term, "Order", as used in the following text refers to the CARO, 2003 issued originally in June 2003 as amended by the Amendment Order issued in November 2004.

The Order supersedes the earlier Order issued in 1988, viz., the Manufacturing and Other Companies (Auditor's Report) Order, 1988 (MAOCARO, 1988).

General Provisions Regarding Auditor's Report

The requirements of the Order are supplemental to the existing provisions of section 227 of the Act regarding the auditor's report. However, there are certain points of distinction between the Order and the requirements of section 227, which are as follows:

(i) the provisions of sub-sections (1A), (2), (3) and (4) of section 227 are applicable to all companies while the Order exempts certain classes of companies from its application; and

(ii) the provisions of sub-section (1A) require the auditor to make certain specific enquiries during the course of his audit. The auditor is, however, not required to report on any of the matters specified in the sub-section unless he has any special comments to make on the said matters. In other words, if he is satisfied with the results of his enquiries, he has no further duty to report that he is so satisfied. The Order, on the other hand, requires a statement on each of the matters specified therein even if he has no comments to make on any of the matter(s) contained in the Order. In that respect, the provisions of the Order are similar to the provisions of sub-sections (2), (3) and (4) of section 227.

Another question that arises is about the status of the Order vis a vis the directions given by the Comptroller and Auditor General of India under section 619 of the Act. In this regard, it may be noted that the Order is supplemental to the directions given by the Comptroller and Auditor General of India under section 619 in respect of government companies. These directions continue to be in force. Therefore, in respect of government companies, the matters specified in the Order will form part of the auditor's report submitted to the members and the replies to the questionnaire issued by the Comptroller and Auditor General of India under section 619 will continue to be furnished as hitherto.

The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein. For example, examination of the system of internal control is one of the basic audit procedures employed by the auditor. The fact that the Order requires a statement regarding the internal control applicable to purchases of inventories, fixed assets and sale of goods only is no justification for the auditor to conclude that an examination of internal control regarding the other areas of a company's business is not important or not required.

Applicability of the Order

Companies Covered by the Order: The Order applies to all companies except certain categories of companies specifically exempted from the application of the Order.

The Order also applies to foreign companies as defined in section 591 of the Act. According to sub-section (1) of the aforesaid section, companies falling under the following two classes are construed as foreign companies:

(a) companies incorporated outside India which, after the commencement of the Act, establish a place of business within India; and

(b) companies incorporated outside India which have, before the commencement of the Act, established a place of business within India and continue to have an established place of business within India at the commencement of the Act.

In respect of foreign companies, an established place of business in India would include a liaison office.

The Order is also applicable to the audits of branch(es) of a company under the Act since sub-section 3(a) of section 228 of the Act clearly specifies that a branch auditor has the same duties in respect of audit as the company's auditor. It is, therefore, necessary that the report submitted by the branch auditor contains a statement on all the matters specified in the Order, except where the company is exempt from the applicability of the Order, to enable the company's auditor to consider the same while complying with the provisions of the Order.

Companies not Covered by the Order

Paragraph 2 of the Order provides that it shall not apply to:

(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);

(ii) an insurance company as defined in clause (21) of section 2 of the Companies Act, 1956 (1 of 1956);

(iii) a company licensed to operate under section 25 of the Companies Act, 1956 (1 of 1956); and

(iv) a private limited company with a paid-up capital and reserves not more than rupees fifty lakh and which does not have outstanding loan exceeding rupees twenty five lakhs from any bank or financial institution and does not have a turnover exceeding rupees five crores at any point of time during the financial year.

The Order specifically exempts banking companies, insurance companies and companies which have been licensed to operate under section 25 of the Act. Section 25 applies to companies which have been formed or are about to be formed as limited companies for promoting commerce, art, science, religion, charity or any other useful object and which apply or intend to apply their profits, if any, or other income in promoting their objects and prohibit the payment of any dividend to their members. Such companies are usually in the form of clubs, chambers of commerce, research institutions, etc. Further, the Order would not also apply in case of non-banking finance company, which converts into a banking company and as on the balance sheet date is a banking company.

The specific exemption under the Order is given to companies licensed under section 25

of the Act. However, it would appear that in view of the provisions of section 656 of the Act, the exemption would also extend to similar companies registered under any earlier Companies Act.

The Order also exempts from its application a private limited company which fulfils all the following conditions throughout the reporting period covered by the audit report:

(i) its paid-up capital and reserves are rupees fifty lakh or less;

(ii) its outstanding loan from any bank or financial institution are rupees twenty five lakh or less; and

(iii) its turnover does not exceed rupees five crore.

A private limited company, in order to be exempt from the applicability of the Order, must satisfy all the conditions mentioned above cumulatively. In other words, even if one of the conditions is not satisfied, a private limited company's auditor has to report on the matters specified in the Order.

(i) Private Limited Company:

The term "private limited company", as used in the Order, should be construed to mean a company registered as a "private company" {as defined in clause (iii) of sub-section (1) of section 3 of the Act} and which has a limited liability. In other words, the Order would be applicable to private unlimited companies irrespective of the size of their paid-up capital and reserves, turnover, borrowings from banks/financial institutions2.

Another important issue to consider in respect of reporting under the Order is the reporting responsibilities of the auditor of a branch of a private limited company in case the branch fulfills the conditions for exemption from the applicability of the Order. In this regard, it may be noted that the conditions to be satisfied for being exempt from the applicability of the Order have been laid down in respect of the company taken as a whole. Therefore, a branch of a company does not qualify to be exempted from the applicability of the Order, if the Order is applicable to the company. The branch auditor has the same reporting responsibilities in respect of the branch as those of the auditor appointed under section 224 of the Act has in respect of the company. The comments of the branch auditor in respect of the branch are dealt with by the auditor of the company appointed under section 224 of the Act while finalizing his report under the Order.

[2] One of the conditions imposed by the Order issued originally in June 2003 for exempting a private limited company was that it should not have accepted any public deposits. The Amendment Order issued in November 2004, however, dropped this requirement in view of the fact that by definition, a private company cannot accept public deposits.

(ii) Paid-up Capital and Reserves

Sub-section (32) of section 2 of the Act defines the term "paid-up capital" as capital credited as paid-up. The Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term "paid-up share capital" as, "that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise". Paid-up share capital would include both equity share capital as well as the preference share capital. While calculating the paid-up capital, amount of calls unpaid should be deducted from and the amount originally paid-up on forfeited shares should be added to the figure of paid-up capital. Share application money received should not be considered as part of the paid-up capital.

The Guidance Note on Terms Used in Financial Statements defines the term "reserve" as, "The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by management for a general or specific purpose other than provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types: capital reserves and revenue reserves". Clause 7(1)(b) of Part III of Schedule VI to the Act also defines the term "reserve" by way of a negative explanation. According to the said definition, the expression "reserve" does not include any amount written off by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability. Thus, a reserve has to be clearly distinguished from a provision.

As mentioned in the preceding paragraph, reserves are primarily of two types–capital reserves and revenue reserves. According to the Guidance Note on Terms Used in Financial Statements, the term "capital reserve" means "a reserve of a corporate enterprise which is not available for distribution as dividend". The said Guidance Note defines the term "revenue reserve" as "any reserve other than capital reserve". For determining the applicability of the Order to a private limited company, both capital as well as revenue reserves should be taken into consideration while computing the limit of rupees fifty lakhs prescribed for paid-up capital and reserves. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance of the profit and loss account, if any, should be reduced from the figure of revenue reserves only. Therefore, if the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures of paid-up capital, capital reserves and revaluation reserves. For example, if the

company has Rs. 40 lakhs of paid up share capital, Rs. 5 lakhs as Revaluation Reserve, Rs. 6 lakhs in Capital Reserve and Rs. 6 lakhs as debit balance in the Profit and Loss Account, the amount of Rs. 6 lakhs standing to the debit of Proft and Loss Account cannot be deducted from the figures of Rs. 11 lakhs, being the total of the Revaluation Reserve and the Capital Reserve. However, miscellaneous expenditure to the extent not written off should not be deducted from the figure of reserves for the purpose of computing the above limit.

(iii) Loan Outstanding

Loans from banks or financial institutions are normally in the form of term loans, demand loans, export credits, working capital limits, cash credits, overdraft facilities, bills purchased or discounted. Outstanding balances of such loans should be considered as loan outstanding for the purpose of computing the limit of rupees twenty five lakhs. Non-fund based credit facilities, to the extent such facilities have devolved and have been converted into fund-based credit facilities, should also be considered as outstanding loan. The figures of outstanding loan would also include the amount of bank guarantees issued by the company where such guarantee(s) has (have) been invoked and encashed or where, say, a Letter of Credit has devolved on the company. In case of term loans, interest accrued and due is considered as a loan whereas interest accrued but not due is not considered as a loan. Further, in case the company enjoys a facility, say, a cash credit facility, whose balance is fluctuating in nature, the Order would apply to the company in case on any day during the financial year concerned, the amount outstanding in the cash credit facility exceeds Rs. 25 lakhs. The condition laid down in the Order is that the outstanding loan from a bank or financial institution is exceeding Rs. 25 lakh. There is no stipulation in the Order that the loan should be a long-term loan or a short-term loan or that it should be a secured loan or an unsecured loan. Therefore, the Order would be applicable to a private limited company even if the loan outstanding is a short-term loan. Further, the condition would also apply notwithstanding the fact that the company has been granted an overdraft facility against, say, fixed deposits, of the company with the concerned bank. Moreover, outstanding dues in respect of credit cards would also be considered while calculating the limit of Rs. 25 lakh in respect of loan outstanding from a bank or financial institution. It is clarified that since the words used by the Order are 'any bank or financial institution', the limit of "exceeding twenty five lakh rupees" would apply in aggregate to all loans and not with reference to each bank or financial institution. For example, if a private limited company has three outstanding loans of rupees nine lakhs each from two banks and a financial institution, the Order would be applicable to such a private limited company.

Another important point to note with respect to loans outstanding is that even in case where the company had taken a loan from a bank in excess of Rs. 25 lacs but the year end balance of the same is NIL, the company would be covered by the Order notwithstanding that it fulfills all other conditions for exemption from the Order.

(iv) Financial Institution

Explanation to sub-clause (xi) of Rule 2(b) of the Companies (Acceptance of Deposits) Rules, 1975 explains the term "financial institution". The term "financial institution" used in the Order should be construed to have the same meaning as assigned to it in the explanation to the said sub-clause in the Companies (Acceptance of Deposits) Rules, 1975. It may, however, be noted that a non-banking financial company is not a "financial institution". A list of financial institutions covered under the Rules is given in Appendix VI to this Statement. Further, private banks or foreign banks are banking institutions under the Banking Regulation Act, 1949. Therefore, loans taken from a private bank or a foreign bank would also be taken into consideration while examining the applicability of the Order

(v) Turnover

The term, "turnover", has not been defined by the Order. Part II of Schedule VI to the Act, however, defines the term "turnover" as the aggregate amount for which sales are effected by the company. It may be noted that the "sales effected" would include sale of goods as well as services rendered by the company. In an agency relationship, turnover is the amount of commission earned by the agent and not the aggregate amount for which sales are effected or services are rendered. The term "turnover" is a commercial term and it should be construed in accordance with the method of accounting regularly employed by the company. For ascertaining the limit of rupees five crores:

(a) sales tax collected or excise duty collected should not be taken into account if they are credited separately to sales tax account or excise duty account;

(b) trade discounts should be deducted from the figure of turnover;

(c) commission allowed to third parties should not be deducted from the figure of turnover;

(d) sales returns should be deducted from the figure of turnover even if the returns are from the sales made in the earlier years. As a corollary, any sales returns etc., in respect of the sales made during the year under report, if received after the end of that year, would not be deductible from the figure of turnover of such year; and

(e) The income received by way of rent or dividend/interest would not form part of "turnover". However, Part II of Schedule VI to the Companies Act, 1956 clarifies that in case of companies rendering or supplying services, gross income derived

from services rendered or supplied, would be shown as turnover. Therefore, in cases where the principal business of the company is letting out of property of the company or it is an investment company, the rent or dividend/interest, respectively, would constitute "turnover".

(vii) Date of Determination of Limits

The Order clarifies the point of time at which various limits laid down by the Order are to be tested for determining its applicability to a private limited company. It clarifies that the Order would become applicable to a private limited company if, at any point of time, during the financial year covered by the audit report:

(a) its paid-up capital and reserves exceed the limit of rupees fifty lakh; or

(b) it has loan outstanding exceeding rupees twenty five lakh, or

(c) its turnover exceeds rupees five crore.

Effective Date of the Order

The Companies (Auditor's Report) Order, 2003 (CARO, 2003) was issued in June 2003 and came into force on the 1st day of July 2003. The said Order, from the date it came into force, superceded the MAOCARO, 1988. Further, the Order requires that every report made by the auditor under section 227 of the Act on the accounts of every company examined by him to which the Order applies, for every financial year ending on any day on or after the commencement of this Order, shall contain matters specified in paragraphs 4 and 5 of the said Order. This implies that the auditor's report, on accounts in respect of financial year ending on or before 30th June 2003, even if issued on or after 1st July 2003 is not required to contain report on matters specified in the CARO, 2003. However, the auditor's report, in such cases, should include a statement on matters specified in the erstwhile MAOCARO, 1988.

The Ministry of Company Affairs of the Government of India, subsequent to issuance of the Order, has issued a Circular numbered, GC No. 32/2003 as regards the date of compliance with the Order. According to the Circular, the companies to whom the Order is applicable should make serious efforts to comply with the new CARO, 2003 from the effective date. In the cases of non-compliance for accounts pertaining to financial year which closes on 31st December 2003 or earlier, Government would take a lenient view provided the accounts at least carry MAOCARO Report, if required. The circular, however, provides that accounts in respect of financial years ending on 1st January 2004 or thereafter, will have to strictly follow the CARO, 2003. The Circular is reproduced in Appendix VII.

The Government's notification notifying the Companies (Auditor's Report) (Amendment) Order, 2004 clarifies that the Amendment Order would be effective from the date of its publication in the Official Gazette; i.e., November 25, 2004. Therefore, all audit reports issued on or after November 25, 2004 are required to comply with amendments contained herein read with the Companies (Auditor's Report) Order, 2003 of June 12, 2003.

The requirements of the Order apply in relation to full financial year irrespective of the fact that a part of such year may fall prior to the date of coming into force of the Order. Under some of the requirements of the Order, the auditor has to comment on the records maintained by the company, systems and procedures in vogue. It is possible that during the period prior to 1st July 2003, many of the companies might not have maintained such records or established such systems and procedures as are envisaged in the Order primarily because such requirements were not part of erstwhile MAOCARO, 1988 and were thus, not required to be commented upon by the auditor. It is advisable that in such situations, the auditor should also clearly mention the fact of non-maintenance of such records or non-existence of systems and procedures while making comments under the relevant clauses.

Reasons to be Stated for Unfavourable or Qualified Answers

Where, in the auditor's report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

7.9 UNQUALIFIED REPORT:

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements. An unqualified opinion indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements. An unqualified opinion also indicates that:

(a) the financial statements have been prepared using the generally accepted accounting principles, which have been consistently applied;

(b) the financial statements comply with relevant statutory requirements and regulations; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

7.9.1 Modified Reports

An auditor's report is considered to be modified when it includes:

(a) Matters That Do Not Affect the Auditor's Opinion

- ✓ emphasis of matter

(b) Matters That Do Affect the Auditor's Opinion

- ✓ qualified opinion
- ✓ disclaimer of opinion
- ✓ adverse opinion

Uniformity in the form and content of each type of modified report will enhance the user's understanding of such reports. Accordingly, this SA includes suggested wordings to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

Matters That Do Not Affect the Auditor's Opinion: In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included preceding the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect. The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem where the going concern question is not resolved and adequate disclosures have been made in the financial statements. The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements. The addition of a paragraph emphasising a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

Matters that Do Affect the Auditor's Opinion: An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(a) there is a limitation on the scope of the auditor's work; or

(b) there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion.

A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. A qualified opinion should be expressed as being 'subject to' or 'except for' the effects of the matter to which the qualification relates.

A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly, unable to express an opinion on the financial statements.

An *adverse opinion* should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the auditor's report. In circumstances where it is not practicable to quantify the effect of modifications made in the audit report accurately, the auditor may do so on the basis of estimates made by the management after carrying out such audit tests as are possible and clearly indicate the fact that the figures are based on management estimates. Ordinarily, this information would be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

7.9.2 Circumstances That May Result in Other Than an Unqualified Opinion

***Limitation on Scope*:** A limitation on the scope of the auditor's work may sometimes be imposed by the entity, for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary. However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists; the auditor should ordinarily not accept such a limited engagement as an audit engagement, unless required by statute. Also, a statutory auditor should not accept such an audit engagement when the limitation infringes on the auditor's statutory duties. A scope limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories. It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

Disagreement with Management: The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

7.10 DISCLOSURE IN THE AUDITOR'S REPORT

The following paragraphs deal with the manner of qualification and the manner of disclosure, if any, to be made in the auditor's report.

AS-1 – DISCLOSURE OF ACCOUNTING POLICIES

In the case of a company, members should quality their audit reports in case –

(a) accounting policies required to be disclosed under Schedule VI or any other provisions of the Companies Act, 1956 have not been disclosed, or

(b) accounts have not been prepared on accrual basis, or

(c) the fundamental accounting assumption of going concern has not been followed and this fact has not been disclosed in the financial statements, or

(d) proper disclosures regarding changes in the accounting policies have not been made.

Where a company has been given a specific exemption regarding any of the matters stated above but the fact of such exemption has not been adequately disclosed in the accounts, the member should mention the fact of exemption in his audit report without necessarily making it a subject matter of audit qualification.

In view of the above, the auditor will have to consider different circumstances whether the audit report has to be qualified or only disclosures have to be given.

In the case of enterprises not governed by the Companies Act, 1956, the member should examine the relevant statute and make suitable qualification in his audit report in case adequate disclosures regarding accounting policies have not been made as per the statutory requirements. Similarly, the member should examine if the fundamental accounting assumptions have been followed in preparing the financial statements or not. In appropriate cases, he should consider whether, keeping in view the requirements of the applicable laws, a qualification in his report is necessary.

In the event of non-compliance by enterprises not governed by the Companies Act, 1956, in situations where the relevant statute does not require such disclosures to be made, the member should make adequate disclosure in his audit report without necessarily making it a subject matter of audit qualification.

In making a qualification / disclosure in the audit report, the auditor should consider the materiality of the relevant item. Thus, the auditor need not make qualification / disclosure in respect of items which, in his judgement, are not material.

A disclosure, which is not a subject matter of audit qualification, should be made in the auditor's report in a manner that it is clear to the reader that the disclosure does not constitute an audit qualification. The paragraph containing the auditor's opinion on true and fair view should not include a reference to the paragraph containing the aforesaid disclosure.

Examples of Disclosures

Where a partnership firm does not make adequate disclosures regarding the revaluation of its fixed assets.

"During the year, the enterprise revalued its land and buildings. The revalued amounts of land and buildings are adequately disclosed in the balance sheet. However, the method adopted to compute the revalued amounts has not been disclosed, which is contrary to Accounting Standard (AS) 10, 'Accounting for Fixed Assets' issued by the Institute of Chartered Accountants of India.

We report that....."

7.11 SPECIMEN REPORT

SPECIMEN AUDITOR'S REPORT TO THE MEMBERS OF THE COMPANY

The Members of .....(*name of the Company*)[1]

1. We have audited the attached balance sheet of ..... *(name of the company)*, as at 31st March 20XX, the profit and loss account and also the {cash flow statement}[2] for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

2. We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

3. As required by the Companies (Auditor's Report) Order, 2003[3] issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act,

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[1] Reference may also be made to the Auditing and Assurance Standard SA 700, The Auditor's Report on Financial Statements, Statement on Qualifications in the Auditor's Report and the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956, issued by the Institute of Chartered Accountants of India.

[2] Wherever applicable.

[3] All references made in this Specimen Auditor's Report to Companies (Auditor's Report) Order, 2003 should be construed as being to the Companies (Auditor's Report) Order, 2003 as amended by Companies (Auditor's Report) (Amendment) Order, 2004.

1956, we enclose in the Annexure[4] a statement on the matters specified in paragraphs 4 and 5 of the said Order.

4. Further to our comments in the Annexure referred to above, we report that:

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) In our opinion, proper books of account as required by law have been kept by the company so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been received from the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with)[5];

(iii) The balance sheet, profit and loss account and {cash flow statement}[6] dealt with by this report are in agreement with the books of account (and with the audited returns from the branches)[7];

(iv) In our opinion, the balance sheet, profit and loss account and {cash flow statement}[8] dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

(v) On the basis of written representations received from the directors, as on 31st March 20XX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 20XX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(vi) In our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

(a) in the case of the balance sheet, of the state of affairs of the company as at 31st March 20XX;

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[4] Alternatively, instead of giving the comments on Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report.

[5] Wherever applicable.

[6] Wherever applicable.

[7] Wherever applicable.

[8] Wherever applicable.

(b) in the case of the profit and loss account, of the profit/loss[9] for the year ended on that date; and

(c) {in the case of the cash flow statement, of the cash flows for the year ended on that date.}[10]

For ABC and Co.
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation)[11]
Membership Number

Place of Signature
Date

Annexure

Re:.....Limited

Referred to in paragraph 3 of our report of even date,

(i) (a) The company has maintained proper records showing full particulars including quantitative details and situation of fixed assets.

(b) All the assets have not been physically verified by the management during the year but there is a regular programme of verification which, in our opinion, is reasonable having regard to the size of the company and the nature of its assets. No material discrepancies were noticed on such verification.

(c) During the year, the company has disposed off a substantial part of the plant and machinery. According to the information and explanations given to us, we are of the opinion that the sale of the said part of plant and machinery has not affected the going concern status of the company.

(ii) (a) The inventory has been physically verified during the year by the management. In our opinion, the frequency of verification is reasonable.

(b) The procedures of physical verification of inventories followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business.

[9] Whichever is applicable.

[10] Wherever applicable.

[11] Partner or proprietor, as the case may be.

(c) The company is maintaining proper records of inventory. The discrepancies noticed on verification between the physical stocks and the book records were not material.

(iii) (a) The company has granted loan to two companies covered in the register maintained under section 301 of the Companies Act, 1956. The maximum amount involved during the year was Rs.20 crores and the year-end balance of loans granted to such parties was Rs. 20 crores.

(b) In our opinion, the rate of interest and other terms and conditions of such loans are not, *prima facie*, prejudicial to the interest of the company.

(c) The parties have repaid the principal amounts as stipulated and have also been regular in the payment of interest to the company.

(d) There is no overdue amount in excess of Rs. 1 lakh in respect of loans granted to companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956.

(e) The company had taken loan from five companies covered in the register maintained under section 301 of the Companies Act, 1956. The maximum amount involved during the year was Rs.50 crores and the year-end balance of loans taken from such parties was Rs. NIL.

(f) In our opinion, the rate of interest and other terms and conditions on which loans have been taken from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956 are not, *prima facie*, prejudicial to the interest of the company.

(g) The company is regular in repaying the principal amounts as stipulated and has been regular in the payment of interest.

(iv) In our opinion and according to the information and explanations given to us, there exists an adequate internal control system commensurate with the size of the company and the nature of its business with regard to purchases of inventory, fixed assets and with regard to the sale of goods and services. During the course of our audit, we have not observed any continuing failure to correct major weaknesses in internal control system of the company.

(v) (a) According to the information and explanations given to us, we are of the opinion that the particulars of all contracts or arrangements that need to be entered into the register maintained under section 301 of the Companies Act, 1956 have been so entered.

(b) In our opinion and according to the information and explanations given to us, the transactions made in pursuance of contracts or arrangements entered in the register

maintained under section 301 of the Companies Act, 1956 and exceeding the value of rupees five lakhs in respect of any party during the year have been made at prices which are reasonable having regard to prevailing market prices at the relevant time.

(vi) In our opinion and according to the information and explanations given to us, the company has complied with the provisions of sections 58A and 58AA and other relevant provisions of the Companies Act, 1956 and the Companies (Acceptance of Deposits) Rules, 1975 with regard to the deposits accepted from the public. No order has been passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal.

(vii) In our opinion, the company has an internal audit system commensurate with the size and nature of its business.

(viii) We have broadly reviewed the books of account relating to materials, labour and other items of cost maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 209 (1) (d) of the Companies Act, 1956 and we are of the opinion that *prima facie* the prescribed accounts and records have been made and maintained.

(ix) (a) The company is regular in depositing with appropriate authorities undisputed statutory dues including provident fund, investor education protection fund, employees' state insurance, income tax, sales tax, wealth tax, service tax, custom duty, excise duty and other material statutory dues applicable to it.

Further, since the Central Government has till date not prescribed the amount of cess payable under section 441A of the Companies Act, 1956, we are not in a position to comment upon the regularity or otherwise of the company in depositing the same.

(b) According to the information and explanations given to us, no undisputed amounts payable in respect of income tax, sales tax, wealth tax, service tax, customs duty and excise duty were in arrears, as at..... for a period of more than six months from the date they became payable.

(c) According to the information and explanation given to us, there are no dues of income tax, sales tax, wealth tax, service tax, customs duty and excise duty which have not been deposited on account of any dispute.

(x) In our opinion, the accumulated losses of the company are not more than fifty percent of its net worth. Further, the company has not incurred cash losses during the financial year covered by our audit and the immediately preceding financial year.

(xi) In our opinion and according to the information and explanations given to us, the company has not defaulted in repayment of dues to a financial institution, bank or debenture holders.

(xii) We are of the opinion that the company has maintained adequate records where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities.

(xiii) In our opinion, the company is not a chit fund or a *nidhi*/mutual benefit fund/society. Therefore, the provisions of clause 4(xiii) of the Companies (Auditor's Report) Order, 2003 are not applicable to the company.

(xiv) In our opinion, the company is not dealing in or trading in shares, securities, debentures and other investments. Accordingly, the provisions of clause 4(xiv) of the Companies (Auditor's Report) Order, 2003 are not applicable to the company.

(xv) In our opinion, the terms and conditions on which the company has given guarantees for loans taken by others from banks or financial institutions are not prejudicial to the interest of the company.

(xvi) In our opinion, the term loans have been applied for the purpose for which they were raised.

(xvii) According to the information and explanations given to us and on an overall examination of the balance sheet of the company, we report that the no funds raised on short-term basis have been used for long-term investment.

(xviii) According to the information and explanations given to us, the company has made preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Act. In our opinion, the price at which shares have been issued is not prejudicial to the interest of the company.

(xix) According to the information and explanations given to us, during the period covered by our audit report, the company had issued 1,00,000 debentures of Rs. 100 each. The company has created security in respect of debentures issued.

(xx) We have verified the end use of money raised by public issues from the draft prospectus filed with SEBI, the offer document and as disclosed in the notes to the financial statements.

(xxi) According to the information and explanations given to us, no fraud on or by the company has been noticed or reported during the course of our audit.

For ABC and Co.,
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation)[12]
Membership Number

Place of Signature

Date

7.12 SIGNING OF THE AUDIT REPORT

As laid down by section 229 of the Companies Act, 1956 only the person appointed as the auditor of the company or where a firm is so appointed, only a partner in the firm practising in India may sign the auditor's report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

The Department of Company Affairs, Government of India, in a communication dated 29th July, 1972 has expressed the view that when a single chartered accountant is practising, there cannot be any question of any firm name. Further it is stated that section 229 of the Act clearly provides that if a firm of chartered accountants is appointed as auditor, only a partner in the firm may sign the auditor's report or sign or authenticate any other document required by law to be signed by the auditor. The practice of merely affixing the 'firm name' on the report or such other document is not correct in the eyes of law. In the Department's view, the partner concerned should invariably sign in his own hand for and on behalf of the firm appointed to audit and the company's accounts. The practice of a separate disclosure to the Registrar of Companies about the identity of the partner of a firm the name of which is affixed to the auditor's report and other documents annexed thereto would not suffice and is not a procedure contemplated by the statute.

Penalty for non-compliance - If any auditor's report or any document of the company is signed or authenticated otherwise than in conformity with the requirements of section 229, the auditor concerned and the person, if any, other than the auditor who signs the report or signs or authenticates the document shall, if the default is wilful, be punishable with a fine which may extend upto Rs. 10,000/- (section 233).

[12] Partner or Proprietor, as the case may be.

Reading and inspection of auditor's report - The auditor's report must be read before the shareholders of the company in general meeting and should be kept open for the inspection of every member of the company (section 230).

It is no part of duty of the auditor either to send a copy of his report to or allow inspection thereof by each member of the company individually or to see that the report is read before the company in general meeting. For non-compliance with any of the requirements of sections 225 to 231, the company, and every officer of the company who is in default, will be liable to a fine which may extend up to Rs. 5000/- (section 232).

In *Re Allen Craig & Co. (London) Ltd.* 1934, it was held that the duty of the auditors, after having signed the report to be annexed to a balance sheet, is confined only to forwarding that report to the secretary of the company. It will be for the secretary or the directors to convene a general meeting and send the balance sheet and report to members (or other persons) entitled to receive it.

7.13 THE AUDITOR'S LIEN

In terms of the general principles of law, any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non payment of fees, for work done on the books and documents. The Institute of Chartered Accountants in England and Wales has expressed a similar view on the following conditions :

(i) Documents retained must belong to the client who owes the money.

(ii) Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the Board of Directors.

(iii) The auditor can retain the documents only if he has done work on the documents assigned to him.

(iv) Such of the documents can be retained which are connected with the work on which fees have not been paid.

Under section 209 of the Act, books of account of a company must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. However, in both the Acts, further provisions are there under which books of account could be kept at a different place, pursuant to a

Board resolution of which notice must be given to Registrar of Companies. If in a company Board passes such a resolution and hands over the books of account to the auditor and makes the necessary notification to the Registrar the auditor may in such circumstances, exercise the right of lien for non-payment of fees. However, as per section 209 he must provide reasonable facility for inspection of the books of account by directors and others authorised to inspect under the Act. Taking an overall view of the matter, it seems that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints. His working papers being his own property, the question of lien, on them does not arise.

SA 230 issued by ICAI on Documentation also states that, "working papers are the property of the auditor. The auditor may at his discretion make portions of or extracts from his working papers available to his clients. The auditor should also adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a period of time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of record retention".

7.14 AUDIT OF BRANCH OFFICE ACCOUNTS

The accounts of the branch office of a company are required to be audited either by the company's auditor appointed under section 224 or by a person qualified for appointment as contemplated by section 226 or, where the branch office is situated in a foreign country, either by the company's auditor or by a person qualified as aforementioned or by an accountant duly qualified to act as an auditor in accordance with the laws of that foreign country [section 228(1)].

In case they are audited by a person other than the company's auditor, the latter would have a right to visit branch office, if necessary, and also to have access at all times to the books and accounts and vouchers maintained at the branch office except in the case of a banking company having foreign branch office, in which case it would be sufficient if the auditor of the company is allowed access to such copies of and extracts from the books and accounts of the branch as have been transmitted to the head office in India [section 228(2) and proviso therein].

A company may at general meeting decide whether it shall have accounts of its branch office audited by a person other than the company's auditor. Upon such a decision being taken, the company may either appoint a person who may be a person qualified under section 226 or, in the case of a foreign branch a person qualified according to the laws of that country to audit the accounts of the branch or authorise the Board of Directors to appoint such an auditor in consultation with the company's auditor. The auditor so

appointed in either case will have the same powers and duties as the statutory auditor and will be paid such remuneration as the company in general meeting or the Board may fix. It will be the duty of the branch auditor to prepare a report on the accounts of the branch office examined by him and to forward the same to the company's auditor who shall, while preparing his report deal with the same in such manner as he considers necessary [section 228(3)].

When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the audit of the accounts of the branch and the audit of the company as a whole; also, there is great necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of the Institute of Chartered Accountants of India have dealt with these issues in SA 600, "Using the Work of Another Auditor" . It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of account and other records of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinarily perform the following procedures:

(a) *advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and*

(b) *advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.*

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Exemptions to Branches: To prevent any hardship, the Central Government has been empowered to make Rules so as to exempt branch offices from audit to extent as is specified in the Rules [section 228(4)]. In exercise of the powers conferred by section 228(4) the Central Government has framed certain rules, entitled. "The Companies (Branch Audit Exemption) Rules, 1961".

These rules are summarised below :

(1) *Exemption based on quantum of activity* - If a company, carrying on any manufacturing, processing or trading activity, has a branch office whose average of the 'quantum of activity' *i.e.* (*i*) the aggregate value of the goods and articles produced, manufactured or processed, or (*ii*) the aggregate value of the goods or articles sold and of service rendered, or (*iii*) the amount of the expenditure, whether of a revenue or capital nature, incurred by a branch office of a company during a financial year, (*i.e.*, the financial year of the company in respect of which exemption from branch audit is to be determined) does not exceed Rs. 2 lakhs or 2% of the average of the total turnover of the company including all its branches and other offices and the earnings from services rendered and from any source during the same period, whichever is higher, the branch office shall be exempted from the provisions of section 228. It may be noted that in any such case, the auditors of the company shall have the rights referred to in section 229(2) relating to the audit of accounts of the branch office (Rules 2 and 3). For this exemption there is no necessity to make any application.

(2) *Grant of exemption in certain other cases* - When an application for exemption is made to the Central Government, it may, after making the necessary inquiry, exempt the branch office from the provisions of audit in section 228 on any one of the following grounds, viz.

(i) that the company carrying on activities other than those of manufacturing or processing, or trading, has made satisfactory arrangements for the security and check, at regular intervals, of the accounts of the branch office by a responsible person competent to scrutinise and check the accounts;

(ii) that the company has made arrangements for the audit of the accounts of the branch office by a person otherwise qualified for appointment as branch auditors, even though such a person is an employee of the company;

(iii) that having regard to the nature and the quantum of activity carried on at the branch office or for any other reason a branch auditor is not likely to be available at a reasonable cost; and

(iv) that, for any other reason, the Central Government is satisfied that exemption may be granted.

A copy of the Central Government's order or exemption is required to be forwarded to the company which shall forthwith send a copy thereof to the auditor of the company and shall also cause it to be read before the next general meeting (Rule 4).

(3) *Condition of exemption in certain cases* - In every case in which an exemption is granted on the ground referred to in clause (*ii*) of the foregoing paragraph, the company shall afford such a person access, at all the times, to the books, accounts and vouchers maintained at the branch office and also shall furnish him with such information and explanation as he may require. Such a person, during the period of exemption, is required to prepare in respect of each financial year, a report on the accounts of the branch office examined by him, as well as, to forward the same to the company's auditor. A certificate to the effect that no material change had taken place in the arrangements made for the audit of the accounts of the branch office shall have to be attached to the balance sheet for each financial year. Such a certificate shall be signed by the manager or secretary of the company and by two directors, one of whom shall be managing director where there is one (Rule 6).

7.15 JOINT AUDIT

The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work. This is by itself a great advantage. In specific terms the advantages that flow may be the following:

(i) Sharing of expertise

(ii) Advantage of mutual consultation

(iii) Lower workload

(iv) Better quality of performance

(v) Improved service to the client

(vi) Displacement of the auditor of the company taken over in a take - over often obviated,

(vii) In respect of multi-national companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.

(viii) Lower staff development costs.

(ix) Lower costs to carry out the work.

(x) A sense of healthy competition towards a better performance.

The general disadvantages may be the following:

(i) The fees being shared.

(ii) Psychological problem where firms of different standing are associated in the joint audit.

(iii) General superiority complexes of some auditors.

(iv) Problems of co-ordination of the work.

(v) Areas of work of common concern being neglected.

(vi) Uncertainty about the liability for the work done.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible –

(a) in respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) in respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors. It may, however, be clarified that all the joint auditors are responsible only in respect of the appropriateness of the decisions concerning the nature, timing or extent of the audit procedures agreed upon among them; proper execution of these audit procedures is the separate and specific responsibility of the joint auditor concerned;

(c) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;

(d) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(e) for ensuring that the audit report complies with the requirements of the relevant statute.

If any matters of the nature referred to in paragraph 4 above are brought to the attention of the entity or other joint auditors by an auditor after the audit report has been submitted, the other joint auditors would not be responsible for those matters.

7.16 SPECIAL AUDIT

Section 233 A empowers the Central Government, in certain cases, to call for a 'special audit'. Such an audit may be required where the Central Government has reasons to believe:

(i) that the affairs of the company are not being managed on sound business principles or according to prudent commercial practices; or

(ii) that the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(iii) that the financial position of the company is such as might endanger its solvency.

Such an audit aims at providing the Government with a critical appreciation of the company and its financial position.

The audit may be conducted either by the company's auditor or another chartered accountant who may or may not be engaged in a practice, appointed by the Central Government [Sections 233(1) and (2)].

The auditor so appointed has the same powers and duties in the matter of special audit as the statutory auditor of a company has under section 227, except for the fact that he must report to the Central Government in place of the members of the company [Sub-section (3)].

The special auditor's report must include, as far as may be practicable, all the matters required to be included in a normal auditor's report under section 227 and where the Central Government so directs, also a statement on any matters which may be referred to him by that Government [Sub-section (4)].

With a view to facilitating the work of the auditor the Central Government may serve an order to furnish to him all such information as he may be in need of non-compliance with such an order of the government shall render the defaulter punishable with a fine extending to Rs. 500 [Sub-section (5)].

On receipt of the report, the Central Government may take such action as circumstances might warrant, according to the provisions of the Act or any other law for the time being in force. In case the Central Government does not take any action within four months from the receipt of the report, it must send the report to the company either to circulate the copy or the extracts among the members or to get it read before the company at its next general meeting [Sub-section (6)].

The expenses of or incidental to a special audit, including the remuneration of the special auditor as fixed by the Central Government (and its decision in this regard is final), must be paid by the company. If the company defaults in making the payment, the amount can be recovered from the company as arrears of land revenue [Sub-section (6)].

7.17 COST AUDIT

It is an audit process for verifying the cost of manufacture or production of any article, on the basis of accounts as regards utilisation of material or labour or other items of costs, maintained by the company.

According to sub-section (2) of section 233(B), a cost auditor shall be appointed by the Board of Directors of the company in accordance with the provisions of sub-section (1B) of section 224 and with the previous approval of the Central Government. Further it has been provided that before the appointment of any cost auditor is made by the Board a written certificate shall be obtained by the Board from the auditor proposed to be so appointed to the effect that the appointment, if made, will be in accordance with the provisions of sub-section (1B) of section 224.

Such a company is required under clause (*d*) of sub-section (1) of section 209 of the Act to include in its books of account, the particulars referred to therein. The cost audit is in addition to, and independent of the normal financial audit carried out pursuant to the appointment under section 224 of the Act. The cost auditor shall have the same powers and duties as are prescribed under section 227(1) of the Act for the auditors appointed under section 224.

Qualification of a Cost Auditor - Under the provisions of section 233B such an audit is to be conducted by a Cost Accountant within the meaning of the Cost and Works Accountants Act, 1959

Disqualification for a cost auditor - These are the following :

(i) Disqualifications contained in sections 226(3) and 226(4) of the Act.

(ii) Holding appointment as the statutory auditor under section 224 of the Act.

(iii) On becoming subject to any of the disqualifications mentioned in (*i*) and (*ii*) and above after being appointed as the cost auditor.

According to sub-section (1) of section 233(B), the auditor appointed under that section is expected to conduct the audit in such manner as may be specified in the order issued by the Central Government. Further, as required by sub-section (4), the cost auditor must forward his report to the Central Government and to the company which 120 days of the closing of the year to which the audit related. The report is to be given in the form prescribed for the purpose.

The Central Government has issued Cost Audit (Report) Rules, 1968 specifying the form of the report and the additional information which should be included therein in the form of annexure. The rules have also set down the various points on which the auditor should make his observations and give his conclusions. The rules have been superceded by a Cost Audit (Report) Rules, 2001.

The auditor must further report on the adequacy of cost accounting records maintained by the company as prescribed by the Government under section 209(1)(*d*) of the Act to confirm that they give a true and fair view of the cost of production processing, manufacturing, or mining activities, as the case may be. If there is any additional information that auditor would like to furnish, he may include in the annexure to the report. The Government has issued notification under section 209(1)(*d*) for various industries. With each notification a Schedule is attached containing detailed items under which the cost of production must be analysed to arrive at the total cost. Each industry concerned is expected to complete the schedule within three months from the expiration of the last date of the period to which it relates. It is the duty of the cost auditor to report on the correctness of the figures given in the schedule. Some of the industries covered by the Cost (Records) Rules, issued under section 209(1)(*d*) are as under :

(i) cement or clinker or both;

(ii) cycles and components thereof;

(iii) caustic soda;

(iv) rubber tyres or tubes or both;

(v) refrigerators;

(vi) storage batteries used in automobiles;

(vii) electric lamps or fluorescent tubes or bulbs;

(viii) room air conditioners;

(ix) motor vehicles;

(x) electric fans;

(xi) electric motors;

(xii) tractors;

(xiii) bulk drugs;

(xiv) vanaspati;

(xv) infant milk food;

(xvi) steel tubes and pipes;

(xvii) power-driven pumps;

(xviii) diesel engines; and

(xix) electric cables and conductors.

The Government's view, so far as it can be ascertained from the pronouncement is that cost audit will not be required annually but only for the financial year or years specified in the order.

The copy of the cost audit report sent to the Central Government should be sent to the company concerned simultaneously. The company shall within 30 days, from the date of the receipt of the copy of report, furnish the Central Government with full information and explanations on every reservation or qualification contained in such report. The Central Government, after consideration of the report and the information and the explanations furnished by the company, may seek further explanation from the company if it so needs. The Central Government may direct the company concerned to circulate to its members along with the notice of the annual general meeting to be held for the first time after submitting of the relevant cost audit report, the whole or part of the report as it may specify.

7.18 STATUTORY REPORT

Statutory audit of a public company implies the audit of the transactions of the company which are the subject-matter of the report under section 165(4). The auditor, however, has to certify as correct only as much of the Statutory Report as relates to the shares allotted by the company, cash received in respect of such shares and other receipts and payments of the company. The auditor, therefore, must:

(a) examine the internal check with regard to the control over amounts collected; and

(b) study the Memorandum, Articles of Association and the Prospectus for ascertaining the amount of authorised capital, its composition, terms of issue, particulars of any underwriting contract entered into, the rate of underwriting commission, shares agreed to be issued for consideration other than cash and particulars of important agreements entered into by the company.

In addition, he should carry out an audit of the issue of shares. The undermentioned steps are also necessary :

(1) Vouch the payment of the underwriting commission.

(2) Vouch the brokerage paid on issue of shares by examining the applications and confirming that they bear the stamps of the brokers or agents to whom brokerage has been paid. Refer to minutes of the Directors authorising the payment of such brokerage. Also see that the provisions of section 76 have not been contravened.

(3) Vouch the payment of Preliminary Expenses and see that the amount paid does not exceed the amount fixed by the Articles or the Prospectus.

(4) Vouch all other receipts and payments of the company up to date within seven days of the report; pay special attention to receipts and payments on capital account, *e.g.*, sale proceeds of assets acquired from the vendor of the business, payments made to him, purchase of fixed assets, etc.

(5) Check in detail amounts deposited in the bank and withdrawals thereof with the entries in the Bank Pass Book. Obtain a certificate from the Bank as to the bank balance as at the date upto which the Statutory Report has been prepared.

(6) Verify that the amounts receivable and payable which have been adjusted in the books of account but have been excluded from the balance of receipts and payments.

The statutory audit culminates in the preparation of the Statutory Report. Its main content, with which the audit is concerned, is the Abstract of Receipts and payments made upto a date within 7 days of the report, exhibiting under distinctive heads, receipts of the company from shares, debentures and other sources, payment made and balance

left in hand. The Statutory Report is required to be certified by the auditors of the company, in so far as the report relates to shares allotted by the company, cash received in respect of which the checking of accounts, as per details given above, has been carried out.

Self-examination questions

1. Are the undermentioned statements true?

   (i) The first auditor of a public limited company is appointed at the statutory meeting.

   (ii) An auditor holds office till the conclusion of the next annual general meeting.

   (iii) Directors may appoint an auditor to fill the vacancy occurring in the middle of the year, whatever be the cause.

   (iv) A new 'auditor' must inform the Registrar of his acceptance of the office of auditor but he need not do so if he does not accept the office.

   (v) A retiring auditor is re-appointed automatically unless there is a specific resolution to the contrary or he is disqualified.

   (vi) A company may delegate authority to the Board of Directors for appointing auditors of the company.

   (vii) The internal auditor as well as the statutory auditor are both appointed by the members in general meeting.

   (viii) An auditor is removed by the same authority by which is appointed.

   (ix) No officer or employee of a company may be appointed auditor of the company.

   (x) An auditor is invariably appointed by an ordinary resolution.

   (xi) Government companies are also to be considered for the ceiling on the number of audits.

2. State the letter, the statement in which will correctly complete the sentences given below:

   (i) The auditor will be guilty of negligence :

      (a) if it is subsequently discovered that the final statements of account were not fully correct.

      (b) when it is found that he did not exercise reasonable care and skill.

      (c) when someone suffers a loss by dealing in the company shares.

(ii) When the client company employs a chartered accountant as an internal auditor, the external auditor :

(a) need not check the areas covered by internal audit.

(b) should ignore the existence of internal audit.

(c) should incorporate the internal auditor's report with his own.

(d) should examine the system and efficiency of internal audit and devise a suitable audit programme.

3. What are the points to be considered by the auditor of a company before expressing opinion in respect of the following :

(a) Statutory Report of a Public Company.

(b) Audit Report to be attached to a Prospectus.

4. (a) What is a statutory report ?

(b) Give briefly the contents of a statutory report.

(c) How is the statutory report authenticated ?

(d) Give the specimen of the auditor's certificate appended to the statutory report.

5. Express your views in brief on the following :

(a) In the annual general meeting of the company, no resolution has been passed for re-appointing the retiring auditor nor a new auditor has been appointed in his place.

(b) There is a provision in the Articles of Association of a company which authorises the Managing Director of the company to refuse such information to the auditors of the company if he thinks that such information might help the competitors.

(c) On being removed from the post of the auditor of a company after continuous 15 years of re-appointment the company for his past services.

(d) The auditor of a limited company refused to deliver the books of account of that company which were given to him for the purpose of audit unless his audit fee is paid in full.

You have been appointed as auditor in place of the retiring auditor of a limited company. What instructions you will send to the controller of accounts of the company by which your work will not be held up due to the incompleteness of the records and documents ?

6. What procedure is to be followed by a Company to change:

   (i) the first statutory auditor appointed by the Board, and

   (ii) the existing statutory auditor before the expiry of his term of office.

   Circumstances in which an auditor may be appointed in a limited company other than by ordinary resolution in general meeting.

7. Under what circumstances auditor can be appointed by the following ?

   (i) The Board of Directors.

   (ii) The Shareholders.

   (iii) The Central Government.

8. What procedure is to be followed if a company wishes to change its existing statutory auditor and appoint another firm of auditors ? What are the duties cast on the new appointee in this matter ?

9. What are the provisions of the Companies Act, regarding the appointment of an auditor in the following cases:

   (i) When no auditor has been appointed at the Annual General Meeting.

   (ii) When no General Meeting has been held and no auditor appointed for two years.

   (iii) When it is desired to appoint an auditor other than the retiring auditor.

   (iv) On the resignation of the existing Auditor.

10. (a) How are the first auditors of a limited company appointed ?

    (b) "At any annual general meeting the retiring auditors by whatsoever authority appointed, shall be re-appointed". Is this a correct statement and are there any exceptions thereto ? If so, briefly state them.

    (c) Explain a brief the legal provisions as well as the Schedule VI requirements regarding Auditors' remuneration.

11. (a) State the circumstances when an auditor of a company (other than a company covered by Sections 619 and 619B of the Companies Act, 1956) may be appointed by :

    (i) Members of the company; and

    (ii) Central Government.

    (b) Briefly describe the procedure to be followed for appointment of an auditor in place of a retiring auditor.

12. Briefly discuss the procedure that should be followed at the forthcoming Annual General Meeting in connection with the appointment of a company's auditors, in each of the following circumstances :

    (a) The directors are of the opinion that there should be no change of auditors.

    (b) The directors proposed a change of auditors.

    (c) The present auditors have expressed their unwillingness to accept reappointment.

Multiple Choice Questions

1. Who is responsible for the appointment of statutory auditor of a limited company ?
    (a) Directors of the company
    (b) Members of the company
    (c) The central Government
    (d) All of the above
2. Which of the following sections deal with qualifications of the auditor ?
    (a) Section 226 (1) and section 226 (2)
    (b) Section 224 (1) and section 224 (2)
    (c) Section 226 (3) and section 226 (4)
    (d) Section 224 (3) and section 224 (4)
3. Which of the following statements is not true ?
    (a) A partnership firm can be appointed as a statutory auditor of a limited company.
    (b) Appointment may be made in the name of the firm.
    (c) Majority of the partners should be practicing in India.
    (d) All partners should be chartered accountants.
4. As per the requirements of section 226(3) and 226(4) a person is disqualified from being appointed as a statutory auditor if he holds --
    (a) Equity shares or debentures of the company.
    (b) Equity shares carrying voting rights of the company.
    (c) Shares carrying voting rights of the company.
    (d) Security carrying voting rights of the company.

5. The board of directors shall appoint first auditor of a company --
   (a) Within one month of completion of capital subscription stage of the company.
   (b) Within one month of the promotion of the company.
   (c) Within one month of the commencement of the business of the company.
   (d) Within one month of incorporation of the company.
6. The term of the auditor ship of first auditor would be from the date of appointment till —
   (a) The conclusion of statutory meeting.
   (b) The conclusion of first annual general meeting.
   (c) The conclusion of next general meeting.
   (d) The date of removal.
7. In case the directors fail to appoint first auditor (s), the shareholders shall appoint them at ..... by passing a resolution :
   (a) A general meeting.
   (b) First annual general meeting.
   (c) Statutory meeting
   (d) Annual general meeting.
8. Life Insurance Corporation of India holds twenty five per cent of subscribed capital of XYZ Ltd. The appointment of statutory auditor in XYZ Ltd. Would be by —
   (a) Ordinary resolution
   (b) Special resolution
   (c) Either (a) or (b)
   (d) None of the above.
9. ICICI prudential ,a life insurance company, holds thirty-two per cent of subscribed share capital of Delta Ltd. The statutory auditor of Delta Ltd. Would be appointed by —
   (a) Ordinary resolution
   (b) Special resolution
   (c) Either of the above
   (d) None of the above.

10. Which of the following statement is not true regarding appointment of statutory auditor by the Central Government ?
    (a) Such powers have been conferred upon it by section 224(3).
    (b) If a company fails to appoint an auditor at a general meeting the Central Government may do so.
    (c) If an auditor refuses to accept appointment, the powers of the Central Government can be exercised.
    (d) None of the above.
11. If a casual vacancy in the office of auditor arises by his resignation it should only be billed by the company in a …….
    (a) Board's meeting
    (b) Extraordinary general meeting
    (c) General meeting
    (d) Annual general meeting
12. For the purposes of section 224(1B) the number of partners of a firm which shall be taken into account would be as on the date of —
    (a) Completion of audit
    (b) Auditor's report
    (c) Acceptance of audit
    (d) Starting of audit work.
13. Mr. Narayan, a Chartered Accountant, has nineteen audits. Out of following audits which audits should he accept to ensure he does violate provisions of section 224(1B) —
    (a) Audit of zeba Ltd' a private company.
    (b) Audit of branch of Pointec Ltd, a foreign company.
    (c) Audit of two branches of Virtue Ltd, an Indian company
    (d) All of them
14. Which audit out of the following would not be regarded as one audit for the purposes of sections 224(1B)
    (a) Audit of one branch each of two different companies
    (b) Joint audit
    (c) Audit of head office and branches
    (d) Audit of one or more branches of a company.

15. The auditor of a Government company is appointed by the CAG. His remuneration is fixed by --
    (a) The CAG
    (b) The shareholders in a general meeting
    (c) The shareholders at an annual general meeting.
    (d) The board of directors.
16. The section which contains provisions regarding remuneration of the auditor is----
    (a) Section 224(9)
    (b) Section 224(7)
    (c) Section 224(8)
    (d) Section 224(6)
17. The authority to remove the first auditor before the expiry of the term is with --
    (a) The shareholders in a general meeting
    (b) The shareholders in the first annual general meeting
    (c) The board of directors
    (d) The Central Government.
18. Which of the following statements is not correct regarding removal of first auditor before expiry of the term ?
    (a) He is removed at a general meeting.
    (b) The shareholders are authorised to do so.
    (c) The approval of the Central Government is required for such removal.
    (d) The provisions for such removal are contained in section 224(7)
19. The following statements relate to removal of an auditor at the expiry of his term --
    (i) A special notice of such a resolution should be given to company at least fourteen days before the meeting.
    (ii) The retiring auditor has a right to make representations in writing and get them circulated.
    (iii) The resolution for such removal can be passed only at annual general meeting.
        (a) Only (i)
        (b) Only (ii)
        (c) Only (i) and (iii) are Correct
        (d) All are correct

20. Which of the restring auditor does not have a right to --
    (a) Make written representations
    (b) Get his representations circulated.
    (c) Be heard at the meeting.
    (d) Speak as a member of the company.
21. Who out of the following cannot be appointed as a statutory auditor of the company ?
    (a) Erstwhile director
    (b) Internal auditor
    (c) Relative of a director
    (d) Only (b) and (c)
22. A Statutory auditor has a right of access at all times to --
    (a) Books and accounts of a company
    (b) Books, accounts and documents of the company
    (c) Books, accounts and vouchers of the company
    (d) Notices and documents of the company
23. The auditor has a right to --
    (a) Obtain information and explanations
    (b) Obtain information and explanations form the employees and officers
    (c) Obtain information and explanation necessary for the purpose of audit
    (d) Both (b) and (c)
24. Under which of the following section auditor has a duty to enquire into six specified matters and report by exception ?
    (a) Section 227(4A)
    (b) Section 227(1A)
    (c) Section 227(1A)
    (d) Section 227(A)

25. Which of the following is not correctly matched ? Section under the Companies Act,1956
    (a) Section 56(1)
    (b) Section 165(4)
    (c) Section 488(2)
    (d) Section 292(1)
26. Right to visit branches has been given to the auditor under which section ?
    (a) Section 222(3)
    (b) Section 228(2)
    (c) Section 228(4)
    (d) Section 228(3)
27. Which of the following statements with regard to rules regarding exception from branch audit is not true ?
    (a) A branch office of a company can be granted exemption on the basis of quantum of activity criterion
    (b) If a satisfactory arrangement for scrutiny and check of the books of account of a branch office of a manufacturing company has been made, it can be excepted from branch audit
    (c) Cost consideration should be considered as an important factor/ground for exemption from branch audit
    (d) The auditor should state in his audit report that branch office is exempted by virtue of quantum of activity or any other basis
28. The branch auditor is appointed by ---
    (a) Shareholders in an annual general meeting
    (b) Shareholders in a general meeting
    (c) Board of directors in board's meeting
    (d) Any of the above
29. Auditor of a ..... Company does not have right to visit foreign branches of the company
    (a) Unlimited
    (b) Manufacturing

(c) Banking

(d) Non-profit making

30. Special audit is conducted at the orders of the Central Government. Which section gives it such powers ?

(a) Section 233(A)

(b) Section 233 A

(c) Section 242(A)

(d) Section 242 A

31. Who among the following can be appointed as special auditor by the Central Government ?

(a) The Statutory auditor

(b) Any chartered accountant in practice

(c) Any chartered accounted who is not in practice

(d) All of the above

32. The appointment of cost auditor of a company under section 233B is to be made by —

(a) Shareholders

(b) Central government

(c) The board of directors

(d) Any of the above

33. The cost auditor shall submit his report to --

(a) Shareholders

(b) Central government

(c) Board of directors

(d) Any of the above

34. The ceiling on number of cost audits, a cost auditor can take is --

(a) Twenty

(b) Ten

(c) Twenty five

(d) Law is silent on this issue

35. Who among the following is not disqualified from being appointed as a cost auditor of a limited company ?

    (a) Statutory auditor of the company

    (b) Internal auditor of the company

    (c) A body corporate

    (d) A relative of a director

36. As per Cost Audit (Report) Rules,2001, if within…… of the end of financial year the company and its officers do not make available to the cost auditor, cost accounting records, statements and other books as required for cost audit, he has to intimate this to the Central Government.

    (a) 90 Days

    (b) 135 Days

    (c) 145 Days

    (d) 120 Days

CHAPTER 8

THE COMPANY AUDIT – II

Learning Objectives

After studying this chapter, you will be able to understanding -

- The general considerations in a company audit.
- The procedure of auditing of share capital, debentures, dividends and verification of issue of bonus shares.
- The presentation of financial statement, such as, balance sheet and profit and loss accounts.

The previous chapter basically dealt with provisions relating to company auditor i.e. his qualifications, disqualifications, rights, duties, etc. In this Chapter, we shall concentrate on provisions relating to company accounts, some specific items of financial statements relating to companies and audit thereof. Students are also expected to know in detail the requirements of Schedule VI to the Act, while auditing different items contained in financial statements.

8.1 GENERAL CONSIDERATIONS IN A COMPANY AUDIT

These have to be determined on a consideration of :

(a) objectives of audit;

(b) various provisions in the Companies Act, 1956, especially those concerning accounts and audit; and

(c) the scope of the report that the auditor of a company is required to make in pursuance of the provisions contained in section 227 of the Act.

The objectives of an audit are :

(i) Verification of statements of account so as to express an opinion;

(ii) Detection of errors and frauds; and

(iii) Prevention of occurrence of errors and frauds.

Detection and prevention of frauds and errors were originally regarded as the main objectives of an audit. It was because the auditor, at that time, was looked upon as the watchdog over the assets that the business possessed as well as over its functioning in general. Such a concept of duties of auditors has its origin in the natural distrust that exists among human beings, especially where the course of business dealings involve several persons entrusting their monies or properties to others. So deep rooted is this belief that whenever, on a company being wound up, a fraud or error is discovered, even today there is a public outcry that the auditors should be held responsible for it.

Though the broad objectives of an audit, to this day, continue to be the same as aforementioned, the emphasis has shifted from the detection of frauds and prevention of occurrence of errors to the verification of the statements of account. It is because in the context of present system of management of companies, it is of greater importance that the annual statement of account should exhibit a true and fair state of affairs of their working instead of auditor's time and energy being devoted to tracking down petty frauds and error in accounts, which the internal staff of the company can be entrusted to detect or guard against. The function of an audit primarily, therefore, has come to be regarded as verification of statements of account and expressing an opinion thereon. The expression of opinion lends credibility to financial statements.

However, while conducting the audit, the auditor is expected to bear in mind the possibility of existence of a fraud or other irregularity in accounts. Nonetheless, he is not expected to conduct the audit with the objective of discovering all frauds or irregularities, for if that is to be done, the audit would take an unduly long time and the cost of it would be quite out of proportion to its benefit.

Nevertheless, it is expected that the auditor would be vigilant and watchful and whenever he comes across a circumstance which arouses his suspicion, he should find out whether a fraud, or irregularity, in fact does exist and, if so, whether it is sufficiently material to necessitate qualifications of the audit report.

It is generally accepted that the auditor is not an insurer and does not guarantee that the books of account truly reflect the company's affairs. Such a view is based on the decision in the famous case, *London and General Bank.*

The auditor, thus, is principally responsible for carrying out his duties by exercising due care and skill in consonance with the professional standards. If, despite the fact, any fraud or irregularity in accounts remains undetected, he cannot be held liable for the failure to detect it. Moreover, since the management is primarily responsible for safeguarding the assets and property of the company, the auditor, while framing his audit

programme, is entitled to rely upon the internal controls in this regard instituted by the management based on a proper evaluation.

It would be observed that Companies Act, 1956 also does not contemplate that an auditor is responsible for the detection of errors and frauds, except when they are so material as to vitiate the opinion expressed by him that statements of account exhibit a true and fair state of affairs.

The aforementioned shift of emphasis in the objectives of audit which also has the tacit acceptance of law, has come about primarily due to the extraordinary increase that has taken place in the size of corporate organisations as well as in the volume, complexity and variety of transactions handled by them. On this account, it has become impracticable for the statutory auditor to frame a programme for carrying on a detailed audit for the detection of all frauds and irregularities. He is increasingly obliged to rely on the internal control measures. As such, he is not in a position to give a categorical assurance to the shareholders that there does not exist a fraud or irregularity in the books of account except to the limited extent that the fraud, if any, is not sufficiently material to affect true and fair position exhibited by the statements of account.

The auditor, nonetheless, is required to verify the final statements of account; also to check or verify all the matters affecting them so as to ensure fully that they exhibit a true and fair state of affairs of the business of the company. For the purpose, he may either carry out a detailed examination of the books or relying on the internal control measures in operation, after testing their strength, merely test the accuracy of transaction recorded therein.

It is permissible for an auditor to verify the accuracy of transactions recorded in the books of account by the application of test checks, if he is satisfied that the system of internal control, in operation, is adequate and satisfactory.

One of the refined forms that test checks can take is selection of a representative sample statistically from the area of accounts which is to be test checked and checking in depth the transactions comprised in the sample. Other forms that list checks take are procedural tests. These are applied to a variety of transactions selected from areas of account provided such areas, as selected for test checking, contain a representative sample of the transactions entered into by the concern and the transactions are checked exhaustively.

On this consideration, the practice of verification of transactions by application of test-checks has come to be recognised universally. As against test checking, a detailed checking of 100% of transactions would only reveal arithmetical mistakes but still fail to

ensure true and fair view. In any case, detailed checking would be very time consuming and almost impracticable having regard to size of organisation spread across the globe. However, the conditions under which test checks can be substituted for detailed checking, and the extent of test checks that must be applied in each case, are matters which the auditor must decide having regard to the circumstances of each case.

On this consideration, while conducting the audit of a large business house which has on its staff a qualified accountant, as internal auditor, it is nowadays sometimes possible for the statutory auditor to somewhat reduce the scope and extent of his routine checking. He, instead of going over the facts and figures as have already been examined by a competent and trustworthy internal staff, may limit his checking only to application of testchecks; if however, any significant mistakes are observed in the test period, the scope of the audit is suitably extended.

A consciousness is growing in the profession that a greater co-ordination is possible between the work of the internal auditor and the statutory auditor which, if brought about, would enable the statutory auditor to make use of, to a greater extent, the detailed checking carried on by the internal auditor in the discharge of his duties and responsibilities. The Institute of Chartered Accountants of India has published an Auditing and Assurance Standard (AAS) 7 on the subject.

8.2 SPECIFIC PROVISIONS AS REGARDS ACCOUNTS IN THE COMPANIES ACT, 1956

The provisions in the matter of books of account which a company is required to maintain are contained in section 209 of the Companies Act, 1956. They are briefly summarised below :

(1) Every company must maintain at its registered office proper books of account with regard to :

(a) all sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place;

(b) all sales and purchases of goods by the company;

(c) the assets and liabilities of the company; and

(d) in case, it is a company engaged in production, processing, manufacturing or mining activities, particulars relating to utilisation of material or labour or other items of cost, provided there is such a requirement by the Central Government in respect of the class of companies to which it belongs.

N.B. - It is permissible, however, for all or any of the books of account to be kept at such place in India as the Board of directors may decide but, when a decision in this regard is taken, the company must file with the Registrar of Companies a notice giving full address of the other place.

(2) When a company has a branch office, whether in or outside India, to comply with the aforementioned provisions, the company must maintain proper books of account relating to transactions effected at the branch office, also arrange to obtain from the branch proper summarised returns, at intervals of not more than three months, for being kept at the registered office or the other place.

(3) For the purposes of sub-sections (1) and (2), proper books of account shall not be deemed to be kept with respect to the matters specified therein :

(a) if there are not kept such books as are necessary to give a true and fair view of the state of affairs of the company or branch office, as the case may be, and to explain its transactions; and

(b) if such books are not kept on accrual basis and according to the double entry system of accounting.

(4) The books of account and other books and papers shall be open to inspection by any director during business hours.

(4A) The books of account together with vouchers relevant to any entry made therein for a period of not less than eight years immediately preceding the current year must be preserved by the company in good condition.

(5) If any of the persons referred to in sub-section (6), fails to take reasonable steps to secure compliance with the requirements of law aforementioned or by a wilful act causes any default by the company, he shall be punishable for each offence with imprisonment for a term which may extend to six months or a fine which may extend to Rs. 10000 or with both. But he may be relieved from such a liability if he can show that he has reasonable ground to believe that a competent and responsible person was charged with the duty of seeing that these requirements were complied with and he was in a position to discharge that duty.

(6) Where the company has a managing director or manager, such managing director or manager and all officers and other employees of the company; and where the company has neither a managing director nor manager, every director of the company.

(7) If a person, not being a person referred to in the foregoing paragraph, who has been charged with the duty of seeing that requirements of law in regard to the books of account is complied with, makes a default in doing so, he shall, in respect of each offence, be punishable with a fine which may extend to Rs. 10,000.

Section 541(2) (applicable to a company in the course of winding up) is also relevant.

Inspection of Books of Account, etc. of Companies - Section 209 A provides that the books of account and other books and papers of every company shall be opened to inspection during business hours: (*i*) by the registrar, or (*ii*) by such officer authorised by the Central Government, or (iii) by such officer authorized by the SEBI.

Such inspection may be made without giving any previous notice to the company or any officer thereof.

It shall be the duty of every director, other officer or employee of the company to produce to the person making inspection of such books of account and other books and papers of the company in his custody or control and to furnish him with any statement, information or explanation relating to the affairs of the company as the said person may require to him within such time and at such place as he may specify. Further it shall also be the duty of every director, other officer or employee of the company to give to the person making inspection under this section all assistance in connection with the inspection which the company may be reasonably expected to give.

The person making the inspection is also empowered to make copies of books of account and other books and papers and put any marks of identification in token of the inspection have been made.

The person making the inspection under this section shall make a report to the Central Government.

Annual accounts and balance sheet : Section 210 requires that the Board shall lay before the company at every annual general meeting a balance sheet as at the end of the period and a profit and loss account for that period. In case of a company not carrying on business for profit an income and expenditure account shall be laid.

The profit and loss account shall relate—

(a) in the case of the first annual general meeting of the company, to the period beginning with the incorporation of the company and ending with a day which shall not precede the day of the meeting by more than nine months; and

(b) in the case of any subsequent annual general meeting of the company, to the period beginning with the day immediately after the period for which the account was last submitted and ending with a day which shall not precede the day of the meeting by more than six months, or in cases where an extension of time has been granted for building the meeting under the second proviso to sub-section (1) of section 166, by more than six months and the extension so granted.

The period to which the account aforesaid relates is referred to in this Act as a 'financial year'; and it may be less or more than a calendar year, but it shall not exceed fifteen months:

Provided that it may be extended to eighteen months where special permission has been granted in that behalf by the Registrar.

Constitution of National Advisory Committee on Accounting Standards : Section 210A has been inserted by the Companies (Amendment) Act, 1999 which provides that the Central Government may, by notification in the Official Gazette constitute a National Advisory Committee on Accounting Standards to advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies or class of companies under this Act. A notification constituting the said committee was issued in July 2001 by the Central Government.

Form and contents of balance sheet and profit and loss account : Section 211 states :

(1) Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of this section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government either generally or in any particular case; and in preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "Notes" at the end of that Part :

Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of balance sheet has been specified in or under the Act governing such class of company.

(2) Every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject as the profit or loss of the company for the financial year and shall, subject as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto :

Provided that nothing contained in this sub-section shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity, or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company.

(3) The Central Government may, by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements in Schedule VI if, in its opinion, it is necessary to grant the exemption in the public interest.

Any such exemption may be granted either unconditionally or subject to such conditions as may be specified in the notification.

(3A) Every profit and loss account and balance sheet of the company shall comply with the accounting standards.

(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following namely :—

(a) the deviation from the accounting standards;

(b) the reasons for such deviation; and

(c) the financial effect, if any arising due to such deviation.

(3C) For the purposes of this section, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949 (38 of 1949), as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under sub-section (1) of section 210A :

Provided that the standard of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the accounting standards are prescribed by the Central Government under this sub-section.

(4) The Central Government may, on the application, or with the consent of the Board of directors of the company, by order, modify in relation to that company any of the requirements of this Act as to the matters to be stated in the company's balance sheet or profit and loss account for the purpose of adapting them to the circumstances of the company.

(5) The balance sheet and the profit and loss account of a company shall not be treated as not disclosing a true and fair view of the state of affairs of the company, merely by reason of the fact that they do not disclose—

(i) in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938 (4 of 1938);

(ii) in the case of a banking company, any matters which are not required to be disclosed by the Banking Companies Act, 1949 (10 of 1949);

(iii) in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by both the Indian Electricity Act, 1910 (9 of 1910), and the Electricity (Supply) Act, 1948 (54 of 1948);

(iv) in the case of a company governed by any other special Act for the time being in force, any matters which are not required to be disclosed by that special Act; or

(v) in the case of any company, any matters which are not required to be disclosed by virtue of the provisions contained in Schedule VI or by virtue of a notification issued under sub-section (3) or an order issued under sub-section (4).

(6) For the purposes of this section, except where the context otherwise requires, any reference to a balance sheet or profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by this Act, and allowed by this Act to be given in the form of such notes or documents.

(7) If any such person as is referred to in sub-section (6) of section 209 fails to take all reasonable steps to secure compliance by the company, as respects any accounts laid before the company, in general meeting with the provisions of this section and with the other requirements of this Act as to the matters to be stated in the accounts, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both :

Provided that in any proceedings against a person in respect of an offence under this section, it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that the provisions of this section and the other requirements aforesaid were complied with and was in a position to discharge that duty.

Provided further that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

(8) If any person, not being a person referred to in sub-section (6) of section 209, having been charged by the managing director or manager, or Board of directors, as the case may be, with the duty of seeing that the provisions of this section and the other requirements aforesaid are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months or with fine which may extend to ten thousand rupees, or with both.

Provided that no person shall be sentenced to imprisonment for any such of offence unless it was committed wilfully.

Students may note that sub-section (3A), (3B) and (3C) were added in section 211 making it mandatory on the part of the management of the company to comply with the accounting standards as specified in sub-section (3C). Hence, statutory recognition has been amended to the accounting standards by the legislation. It is incumbent on the company, in case of non-compliance, to mention the fact of deviation, reason for deviation and the financial effect, if any, as well.

Balance sheet of holding company to include certain particulars as to its subsidiaries : Section 212 requires that there shall be attached to the balance sheet of a holding

company having a subsidiary or subsidiaries at the end of the financial year as at which the holding company's balance sheet is made out.

(*Note* : Students may note that as per section 227 of the Act, the duty of the auditor extends to expressing an opinion on balance sheet and profit and loss account and all other documents *annexed* thereto. Since section 212 requires that particulars of subsidiary company are required to be *attached* to balance sheet of holding company, the same shall not be covered by auditor's report. Also refer to section 222 which deals with construction of references to documents annexed to accounts. The Board's Report under section 217 is also attached to every balance sheet of a company.

Profit and loss account to be annexed and auditor's report to be attached to balance sheet - The profit and loss account shall be annexed to the balance sheet and the auditors' report including the auditors' separate, special or supplementary report, if any shall be attached thereto.

Board's report (Section 217):

(1) There shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of directors, with respect to—

(a) the state of company's affairs;

(b) the amounts, if any, which it proposes to carry to any reserves in such balance sheet;

(c) the amount, if any, which it recommends should be paid by way of dividend;

(d) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report;

(e) the conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed.

(2) The Board's report shall, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the Board's opinion be harmful to the business of the company or of any of its subsidiaries, deal with any changes which have occurred during the financial year—

(a) in the nature of the company's business;

(b) in the company's subsidiaries or in the nature of the business carried on by them; and

(c) generally in the classes of business in which the as an interest.

(2A) (a) The Board's report shall also include a statement showing the name of every employee of the company who—

(i) if employed throughout the financial year, was in receipt of remuneration for that year which, in the aggregate, was not less than such sum as may be prescribed; or

(ii) if employed for a part of the financial year, was in receipt of remuneration for any part of that year, at a rate which, in the aggregate, was not less than such sum per month as may be prescribed; or

(iii) if employed throughout the financial year or part thereof, was in receipt of remuneration in that year which, in the aggregate, or as the case may be, at a rate which, in the aggregate, is in excess of that drawn by the managing director or whole-time director or manager and holds by himself or along with his spouse and dependent children, not less than two per cent, of the equity shares of the company.

(b) The statement referred to in clause (*a*) shall also indicate,—

(i) whether any such employee is a relative of any director or manager of the company and if so, the name of such director, and

(ii) such other particulars as may be prescribed.

Explanation : Remuneration has the meaning assigned to it in the *Explanation* to section 198.

(2AA)The board's report shall also include a Directors' Responsibility Statement, indicating therein, -

(i) that in the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;

(ii) that the directors had selected such accounting policies and applied them consistently and made judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for that period;

(iii) that the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(iv) that the directors had prepared the annual accounts on a going concern basis.

(2B) The Board's report shall also specify the reasons for the failure, if any, to complete the buy back within the time specified in sub-section (4) of section 77A.

(3) The Board shall also be bound to give the fullest information and explanations in its report aforesaid, or, in cases falling under the proviso to section 222, in an addendum to that report, on every reservation, qualification or adverse remark contained in the auditors' report.

(4) The Board's report and any addendum thereto shall be signed by its chairman if he is authorised in that behalf by the Board; and where he is not so authorised, shall be signed by such number of directors as are required to sign the balance sheet and the profit and loss account of the company by virtue of sub-sections (1) and (2) of section 215.

(5) If any person, being a director of a company, fails to take all reasonable steps to comply with the provisions of sub-sections (1) to (3), or being, the chairman, signs the Board's report otherwise than in conformity with the provisions of sub-section (4), he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to twenty thousand rupees, or with both :

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully :

Provided further that in any proceedings against a person in respect of an offence under sub-section (1), it shall be a defence to prove that a competent and reliable person was charged with the duty of seeing that the provisions of that sub-section were complied with and was in a position to discharge that duty.

(6) If any person, not being a director, having been charged by the Board of directors with the duty of seeing that the provisions of sub-sections (1) to (3) are complied with, makes default in doing so, he shall, in respect of each offence, be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to twenty thousand rupees, or with both:

Provided that no person shall be sentenced to imprisonment for any such offence unless it was committed wilfully.

8.3 PAYMENT OF INTEREST OUT OF CAPITAL DURING CONSTRUCTION

Under the provisions of section 208, a company which has raised money by issue of shares to meet the cost of construction of any work or building or provision of any plant which cannot be made profitable for a long time, can pay interest on paid-up capital for a period and subject to conditions specified in sub-sections (2) to (7) of section 208. Accordingly, the payment of interest should be verified as follows :—

(a) Ascertain that the payment is authorised by the Articles or by a special resolution.

(b) Verify that the previous sanction of the Central Government for making such payment has been obtained.

(c) Confirm that the interest has been paid only for such period as has been authorised by the Central Government and does not extend beyond the half-year next following during which the construction was completed or the plant was provided.

(d) Verify that the rate of interest shall, in no case exceed such rate as the Central Government may, by notification in official Gazzette direct.

(e) Check that the amount of interest paid has been added to the cost of assets created out of the capital.

The interest paid being a part of the capital expenditure incurred in bringing into existence assets, it should be added thereto. Until so added, it must be shown as a separate item in the Balance Sheet under the head 'Miscellaneous Expenditure'.

8.4 SPECIAL REQUIREMENTS OF COMPANY AUDIT

(i) *Verification of the constitution and powers* - A company can function within the limits prescribed by the documents on the basis of which it has been registered. It raises its capital from the public on certain conditions, specified in the Prospectus. Before commencing business, to purchase a property or to have subscription to its capital underwritten. On this account, it is essential that the auditor, prior to starting the audit of a company, shall examine :

(a) The Memorandum of Association.

(b) The Articles of Association.

(c) Contracts entered into with vendors and other persons relating to purchase of property, payment of commission, etc.

A company cannot enter into a contract before it has been registered. What is more, a public company cannot commence business until the certificate of commencement of business has been granted to it by the Registrar of Companies. It is, therefore, the duty of the auditor to take into account, while examining the transaction entered into by the company, the dates when these were entered into for confirming the validity.

With a view to carrying out the audit effectively, it is necessary that the auditor should know the authority structure of the company. Under Section 291 of the Act, the Board of Directors of a company are entitled to exercise all such powers, and to do all such acts

and things, as the company is authorised to do. However, the Board shall not exercise any power or do any act or thing which is directed or required by any legislation (including the Companies Act) or by the memorandum or articles of the company, to be exercised or done by the company, in general meeting.

Section 292 specifies six types of decisions that can be taken by the Board of Directors only in Board's meetings. These relate to :

(i) making calls on partly paid shares.

(ii) issue of debentures,

(iii) borrowing monies otherwise than on debentures,

(iv) investing the funds of the company, and

(v) making loans.

The transaction barring the first three can be delegated to any of the following :

(a) a committee of directors,

(b) managing director,

(c) manager,

(d) any other principal officer of the company, or

(e) principal officer of the branch office, in relation to the branch.

Apart from the above, a number of other functions are also carried out by the Board. A few of such functions are stated herein by way of examples :

(a) Adopting of accounts before the same submitted to the auditor for their report-Section 215.

(b) Appointment of the first auditors and filling of casual vacancy - Section 224.

(c) Investment in shares of companies within the limits specified in Section 372A.

(d) Entering into contracts with persons who are directors of the company or related to or associated with the directors as are specified in Section 297 of the Act.

Some of the matters which only the shareholders can sanction at a general meeting :

(a) Appointment and fixation of remuneration of auditors in the annual general meeting - Section 224.

(b) Declaration of dividends - Regulation 85, Table A.

(c) Appointment of relatives of directors etc. to an office or place of profit in the company under Section 314 of the Act.

(d) Sale, lease or a disposal of the whole of the company's undertaking or a substantial part of it and donations above a certain limits [Section 293(1)].

(ii) Matters which require sanction of the Central Government :

Loans to directors by a company other than a banking or a finance company (Section 295).

For verifying the foregoing transactions and others authorised by the directors or shareholders, the auditor should refer to the minutes of the meeting at which these have been considered. Further, for judging the validity or otherwise of section accorded, the relevant provision of law must be referred to. A few such instances are given below :

(a) Appointment of Directors (Section 256).

(b) Disqualifications of Directors (Section 274).

(c) Conduct of Board Meeting (Sections 285-290).

(d) General powers of Board (Section 291).

(e) Powers which the Board must exercise only at a meeting (Section 292).

(f) Restriction on powers of the Board regarding disposal of the undertaking or part of it etc. (Section 293).

(g) Prohibitions and restrictions regarding political contributions (Section 293A).

(h) Power of Board and other persons to make contributions to the National Defence Fund, etc. (Section 293B).

(i) Restriction on advancing loans to Directors, etc. (Section 295).

(j) Restriction on a Director or his relative, a firm in which a director or relative is a partner; or any other partner of the firm or a private company of which such a director is a member or director to enter into a contract of sale or purchase of goods except with the sanction of the Board of Directors (Section 297).

(k) Restriction on an interested director in participating in or voting at Board's proceedings (Section 300).

(l) Disclosure of interest by directors (Section 299).

(m) Register of contracts, Companies or firms in which directors are inspected (Section 301)

(n) Remuneration of directors (Section 309).

(o) Restraint on a director's holding offices or places of profit (Section 314).

(p) Restraint on payment of compensation for loss of office to a director (Sections 318 to 321).

(q) Restriction on loans, etc., to companies under the same management (Section 370).

(r) Regulation of inter-corporate loans and investments (Section 372A).

(iii) *Special considerations involved in the examination of certain documents*

(a) *Memorandum of Association* - It is a charter containing particulars of business activities that the company can undertake and the powers it can exercise in regard thereto. Only on a consideration thereof it is possible for the auditor to determine whether a transaction which has been entered into by the company is *intra vires,* i.e. the company is authorised to enter into it. If a company enters into a transaction which is *ultra vires,* the shareholders, though entitled to claim the profit arising on such a transaction, may restrain the management from charging the loss, if any, has been suffered thereon, to the company. If the auditor fails to detect and report the transaction which are *ultra vires* the company, he would be guilty of negligence.

Generally the Memorandum of Association of companies is drawn up comprehensively in order that the company may be able to enter into a wide variety of transactions which it may be required to do for carrying out one or more of its objects. Nevertheless, sometimes occasions arise when a company, inadvertently, or deliberately, enters into a transaction which is *ultra vires* objects to powers. In such a case, the shareholders may decide to restrain the management from charging to the company the losses suffered by the company in respect of such a transaction.

(b) *Articles of Association* - These are rules and regulations for the internal management of the company; and they define the rights of different classes of shareholders, conditions under which calls can be made, the maximum and minimum number of directors the company can have, their qualifications, disqualifications and removal, etc. The terms and conditions of these provisions have relevance to the examination of transaction, that the auditor is required to carry out. He should, therefore, study the Articles and include extracts from them in his permanent audit file. The auditor, who fails to take note of the provisions in the Articles in the verification of statements of accounts, would be guilty of professional negligence. While delivering judgment in the case, *Leeds Estate Building and Investment Co.* v. *Shepherd, Starling J.* said, "It is the duty of the auditor to see that the balance sheet is a true and correct representation of the company's affairs. It was no excuse that the auditor had not seen the articles when he knew of their existence."

The auditor must, therefore, acquaint himself with the provision of the Articles of the company and should apply this knowledge in the verification of the transactions of the company.

(c) *Prospectus* - It is a formal document which a public company must issue before it makes the allotment of shares under section 56. It must contain all the terms and conditions on which subscription to the shares is sought to be obtained from the public *e.g.* the company may stipulate, that it would obtain a quotation for its shares at a Stock Exchange or that it shall purchase a property which is considered valuable for the company or that it has obtained the services of technical experts whose services will be valuable for setting up the factory. In case the company fails to carry out any of these undertakings or if any statement made by it ultimately is proven to be false, the shareholder has the option to claim refund of the amount paid by him. The auditor should, therefore, study carefully all the conditions and stipulations made in the prospectus and, in case any of them has not been carried out, to draw the attention of shareholders thereto. It may be noted that the right to claim refund is restricted to such of the shareholders who subscribed for shares on the basis of prospectus. A shareholder who has purchased the shares from stock exchange or otherwise cannot claim refund.

Section 60A inserted by the Companies (Amendment) Act, 2000 has introduced the concept of "Shelf Prospectus". Such prospectus would enable companies engaged in financial activities to raise money by way of offer of securities more than once during its validity and, in such case, only an information memorandum stating certain material particulars. Section 60B has introduced the concept of "red-herring" prospectus. Accordingly, section 60B involves concept of information memorandum also.

8.5 AUDIT OF SHARE CAPITAL

Almost the first function of a company is to raise capital. Excepting a private company, every other company issues a prospectus, which may be in the abridged form, or a Statement in lieu of Prospectus, before it proceeds to allotment, share capital. The object is to publicly announce the conditions on which allotment will be made, to specify the projects on which the amount raised will be spent (when these have been decided upon in advance) and to specify limits on certain expenses incidental to raising of capital. The receipt of applications for shares and allotment of shares in pursuance thereto are two important aspects of every issue of capital in so far as these constitute the legal basis of the transactions in the matter of purchase of shares. These, therefore, should receive a careful attention of the auditor. He also must verify that each party, has performed his part of the contract, within the allotted time.

The audit of share capital is necessary both on incorporation and afterwards whenever the directors decide to increase the subscribed share capital. However, except when fresh capital has been issued during the year under audit, for verification of capital it is enough if transfers of shares registered during the year are verified and the total number and value of shares held by different shareholders are reconciled with the total paid-up capital of the company.

8.5.1 General Programme for Verification of Share Capital

Authorised capital - The authorised capital may be verified with reference to the amount shown in the Memorandum of Associations. Previous year audited balance sheet may also be seen.

Issued capital - Verify the amount of issued capital with reference to last year audited balance sheet. Also see whether the Central Government has issued any notification for conversion of debenture or loan into equity share under section 94A.

Further issue of capital - The general points are given as under:

(1) Study the conditions of issue contained in the Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, shelf prospectus, red-herring prospectus and information memorandum, as the case may be, and see that all of them have fully been complied with.

(2) Verify that the first allotment was not made until the amount of minimum subscription stated in the Prospectus had been subscribed and until then the amount received was kept deposited in a Scheduled bank as required by Section 69 of the Act.

(3) Confirm that the brokerage and underwriting commission was paid only at the rates authorised by the Prospectus or the Articles of Association, having regard to the provisions contained in Section 76.

(4) Ensure that legal requirements as laid down in section 81 (dealing with right shares) have been complied with.

(5) Verify that preliminary contracts, if any, entered into for purchase of a property or business, for creating an organisation for management of the company, etc. have been carried out strictly according to the terms stated in the Prospectus.

(6) Ensure that the company intending to offer shares to the public for subscription by the issue of a Prospectus has, before such issue, made an application to one or more recognised stock exchanges for permission for the shares intending to be so offered within the stock exchange or each stock exchange as required by the Companies (Amendment) Act, 1988. Section 73 provides that allotment made by a company would

be void if the permission is not granted by stock exchange before the expiry of ten weeks from the date of the closing of the subscription list.

(7) Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) have been followed. Compliance reports submitted by lead managers and reports submitted to SEBI may be examined in this regard.

(8) Ascertain that there exists an internal check on receipt of amounts alongwith the application and that the same throughout has continued to function satisfactorily.

(9) Verify compliance with legal provision relating to issue of shares at premium (section 78), issue of shares at discount (section 79), and issue of sweat equity shares (section 79A)

8.5.2 Verification of Shares Issued for Cash

Usually, there are three stages in the issue of shares for cash, *viz.* :

(i) Receipt of applications for shares alongwith application money;

(ii) Allotment of shares and receipt of allotment; and

(iii) Making calls and receipt of call money.

The programme of work to be carried out in respect of each of the above mentioned three stages is stated below :

(1) *Applications* - Verify the amount received alongwith the applications for shares in the following manner :

  (i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;

  (ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;

  (iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;

  (iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

(2) *Allotment*

  (i) Examine Director's Minutes Book to verify approval of allotments.

  (ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.

(iii) Trace entries in the Cash book into the Application and Allotment Book for the verification of amounts collected on allotment.

(iv) Trace the amount collected on application as well as those on allotment from the Application and Allotment Book into the Share Register.

(v) Check totals of amounts payable on allotment and verify the journal entry debiting Share Allotment Account and crediting Share Capital Account.

(3) *Calls*

(i) Examine the Director's resolution making the call.

(ii) Vouch amounts received with the counterfoils of receipts.

(iii) Trace postings of the amounts received from the Calls Book (for calls due) and the Cash Book (for calls collected) into the Share Register.

(iv) Verify the journal entry, debiting the Call Account and crediting Share Capital with totals of the amounts due.

(v) Note the calls in arrears.

(4) *General*

(i) Ascertain that the nominal value of shares allotted does not, exceed the authorised and issued capital and that allotments were made in accordance with conditions contained in the Prospectus.

(ii) See the returns of allotment have been filed with the Registrar of Companies.

(iii) Extract balances of shareholders' accounts contained in the Share Register and tally their total with the balance in the Share Capital Account.

(iv) If the issue was underwritten, examine the contract with the underwriters to ensure that all obligations under the contracts have been fully satisfied.

(v) Vouch payment of commission and brokerage, the first by reference to the underwriting contract and the second by reference to stamps of brokers on application forms.

(vi) See that the company has delivered share certificates within three months after the allotment of any of its shares in accordance in the procedure laid down under Section 53.

Note : The signatories to the Memorandum of Association being the first shareholder of the company, it is usual to make allotment in their favour.

8.5.3 Shares Issued for Consideration other than Cash

The contract, on the basis of which the shares have been allotted, should be referred to and the allotment confirmed by reference to the Minutes of the Board of Directors. It should also be verified that a copy of the contract as required by Section 75(1)(*b*) of the Act has been filed with the Register of Companies within one month of the date of allotment and in the absence thereof, a memorandum in writing stating particulars of the contract has been filed.

Sometimes, in view of the nature of the transaction, it may be difficult to know whether an allotment is for cash or for a consideration, other than cash, for instance, allotment of shares in adjustment of a debt owed by the company. In such a case, if the allotment is made in adjustment of a *bonafide* debt payable in money at once, the allotment should be considered as against cash. (Spargo's Case 1873, 3 Ch. A 407). This position should be kept in view when inquiring into matters stated in Section 227(1A). Again if the shares are allotted on a cash basis, though the amount is actually paid later, it should constitute an allotment against cash.

8.5.4 Shares Issued at a Premium

Where a company has issued shares at a premium, that is, at amount in excess of the nominal value of the shares, whether for cash or otherwise, Section 78 prescribes that a sum equal to the amount of the premium collected should be transferred to the Securities Premium Account. Since the Act provides that the amount of premium will be considered a part of the share capital and that the amount of premium collected on shares can only be reduced in the manner prescribed for the reduction of capital, the amount of share premium received cannot be forfeited when the shares in respect thereof are forfeited. The auditor should also see compliance with SEBI Guidelines.

8.5.5 Shares Issued at a Discount

A company can issue shares at a discount on the following conditions (Section 79) :

(i) The issue should be authorised by an ordinary resolution of the company and sanctioned by the Central Government.

(ii) No such resolution shall be sanctioned by the Central Government in case the maximum rate of discount should exceed 10 per cent unless the Central Government is of opinion that a higher rate for discount is justified by the special circumstances of the case.

(iii) The issue should be made within two months of the sanction by the Central Government but not earlier than one year after the date of commencement of business.

(iv) The shares should be of a class already issued by the company.

It is the duty of the auditor to confirm that all the conditions aforementioned have been complied with by the company at the time the allotment was made. Though there appears to be no obligation on the part of the company to write off discount on the issue of shares, it is nonetheless advisable that is should be so done within a few years of the shares being issued. The amount of discount, until written of, should be shown separately in the Balance Sheet under the head "Miscellaneous Expenditure".

8.5.6 Issue of Sweat Equity Shares

The Companies (Amendment) Act, 1999 recognised that in the wake of globalisation of corporate sector, the employees will have to be rewarded suitably to share in the growth of company. By insertion of section 79A, the employees may be compensated in the form of "sweat equity shares". As per explanation to section 79A, the expression "sweat equity shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. The auditor may see that the sweat equity shares issued by the company are of a class of shares already issued and following conditions are fulfilled :

(a) The issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;

(b) The resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(c) Not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business;

(d) The sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities Exchange Board of India in this behalf:

Provided that in the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

For the purposes of this sub-section, the expression "a company" means the company incorporated, formed and registered under this Act and includes its subsidiary company incorporated in a country outside India.

8.5.7 Power of Company to Purchase its Own Securities

The Companies (Amendment) Act, 1999 contains elaborate provisions enabling a company to buy-back its own securities. The word security here includes employee stock option, *i.e.,* sweat equity share or any other security notified by the government. The word security includes both equity and preference share. But preference share can be redeemed, perhaps the reform is intended to equity share only. As per section 77A, a company may purchase its own shares or other specified securities (hereinafter referred to as "buy-back") out of—

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of any earlier issue other than from issue of shares made specifically for buy-back purposes.

(2) No company shall purchase its own shares or other specified securities unless—

(a) the buy-back is authorised by its articles;

(b) a special resolution has been passed in general meeting of the company authorising the buy-back;

Provided that nothing contained in this clause shall apply in any case where (i) the buy-back is or less than 10 percent of the total paid-up equity capital and free reserve of the company and (ii) such buy-back has been authorized by the Board by means of a resolution passed at its meeting.

(c) the buy-back is or less than twenty-five per cent, of the total paid-up capital (equity shares and preference shares) and free reserves of the company;

(d) The debt-equity ratio is not more than 2 : 1 after such buy-back :

Explanation.—For the purposes of this clause, the expression "debt" includes all amounts of unsecured and secured debts;

(e) all the shares or other specified securities are fully paid-up;

(f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India;

(g) the buy-back in respect of shares or other specified securities other than those specified in clause (*f*) is in accordance with the guidelines as may be prescribed.

(3) The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating—

(a) a full and complete disclosure of all material facts;

(b) the necessary for the buy-back;

(c) the class of security intended to be purchased;

(d) the amount to be invested; and

(e) the time limit for completion of buy-back.

(4) Every buy-back shall be completed within twelve months from the date of passing the special resolution.

(5) The buy-back under sub-section (1) may be—

(a) from the existing security holders on a proportionate basis; or

(b) from the open market; or

(c) from odd lots,

(d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(6) A solvency certificate to be filed before making buy-back.

(7) A company buy-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

(8) A company shall not make further issue of same kind of shares (including allotment of further shares under clause (*a*) of sub-section (1) of section 81) or other specified securities within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

(9) A company maintains a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of existing and physically destroying of securities and such other particulars as may be prescribed.

(10) A company shall, after completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed :

Provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

The auditor should ensure that the proper accounting entries have been passed immediately after the buy-back. Further prohibition to buy-back shares is contained in section 77B.

8.5.8 Calls Paid in Advance

A company, if permitted by the articles, may accept from members, either the whole or part of the amount remaining unpaid on any shares held by him as calls in advance; but the amount so received cannot be treated as a part of the capital for the purpose of any voting rights until the same becomes presently payable and duly appropriated. A company, if so authorised by its Articles, may pay dividend in proportion to the amount paid upon each share, where a larger amount is paid up on some shares than that on other (Section 93). It may be noted that Clause 88(2) of Table A does not permit calls in advance being treated as amounts paid up on shares for the purpose of payment of dividends.

Unless the company exercises the right as aforementioned, the shareholders who have paid calls in advance would be entitled to receive interest at the rate specified in the Articles. The interest on calls in advance, though chargeable against profits, also can be paid out of capital when profits are not available for such a payment. In the event of a winding up, calls in advance repayable alongwith interest accrued thereon before any part of the capital is returned to shareholders.

8.5.9 Calls in Arrears

The amounts due from shareholders in respect of calls in arrears should be verified by reference to the Share register. If any calls are due from Directors, they should be shown separately in the balance sheet. Often the Articles provide that interest be charged on calls in arrears. The adjustment of interest in such a case should be verified.

8.5.10 Issue and Redemption of Preference Shares

(a) *Power to issue redeemable preference shares :* A company limited by shares, if authorised by its articles, may issue preference shares which are liable to be redeemed at the option of the company before or on an appointed date. However, after the commencement of the Companies (Amendment) Act, 1996 no company limited by shares shall issue any preference share which is irredeemable or is redeemable after the expiry

of a period of 20 years from the date of its issue. So long as the shares are not redeemed, the terms of redemption or conversion must be stated in the balance sheet together with the earliest date of redemption or conversion.

In the matter of redemption of shares the auditor should confirm that the requirements of Section 80 have been complied with, *viz.* :

(i) that the shares redeemed were fully paid up;

(ii) that the shares were redeemed out of profit available for distribution as dividend or out of proceeds of a fresh issue made for purpose of redemption;

(iii) that the premium if any, on redemption, was provided for either out of the Securities Premium Account or out of divisible profits of the company; and

(iv) that if the shares were redeemed out of profits, otherwise available for dividend, an amount equal to nominal amount of shares redeemed has been transferred to the Capital Redemption Reserve Account.

The Capital Redemption Reserve Account is treated as part of capital in the same way as Securities Premium Account. It cannot, therefore, be applied except for paying up unissued share capital of the company to be issued to members as fully paid up bonus shares.

(b) *Redemption of irredeemable preference shares :* Section 80-A inserted by the Companies (Amendment) Act, 1988 requires that irrespective of the fact anything contained in the terms of issue of any preference shares, every preference share issued before the commencement of this said Act, which is irredeemable shall be redeemed by the company within a period not exceeding 5 years from the date of due thereon in accordance with the terms of its issue and which had not been redeemed before such commencement be redeemed by the company on the date of which such share is due for redemption or within a period not exceeding 10 years from such commencement whichever is earlier.

Provided that where a company is not in a position to redeem any such share within the period aforesaid and to pay the dividend, if any, due thereon (such shares being hereinafter refer to as unredeemed preference shares), the company may with the consent of the Tribunal on a petition made by it in this behalf and not withstanding anything contained in this Act, issue further redeemable preference shares equal to the amounts due to (including the dividend due thereon) in respect of the unredeemed preference shares and on the issue of such further redeemable preference shares, the unredeemed shares shall be deemed to have been redeemed.

8.5.11 Alteration of Share Capital

A company, having a share capital, if so authorised by its Articles, may alter its share capital by an ordinary resolution without confirmation of the Court, in any of the manners authorised by Section 94. Each alteration made should be noted in every copy of the Memorandum of Articles issued subsequent to date of the alteration (Section 40). The auditor's duties in the circumstances shall be:

(i) to verify that the alteration of capital is authorised by the Articles;

(ii) to inspect the minutes of the shareholders authorising the alteration;

(iii) to obtain Allotment Lists containing details of the new holdings of share or stock by each member and to verify the same with the entries.

(iv) to inspect the directors' resolution in regard to allotment, consolidation, conversion or sub-division passed pursuant to the resolution of the members;

(v) to examine the cancelled share certificates, if any, and agree the same with the counterfoils of new certificates issued;

(iv) to see that the procedure, prescribed by the Articles in this regard, has been complied with;

(vii) to verify that the share capital account is correctly shown in the Balance Sheet; and

(viii) to see that the necessary intimation to the Registrar contemplated by Section 95 has been sent.

8.5.12 Reduction of Capital (Section 100)

The duties of the auditor in this regard are following :

(i) Verifying that the meeting of the shareholder held to pass the special resolution was properly convened; also that the proposal was circularised in advance among the members.

(ii) Confirming that the Articles of Association authorise reduction of capital.

(iii) Examining the order of the Tribunal confirming the reduction and seeing that a copy of the order and the minutes have been registered and filed with the Registrar of Companies.

(iv) Inspecting the Registrar's Certificate as regards reduction of capital.

(v) Vouching the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence; also seeing that the requirements of Schedule VI, Part I, have been complied with.

(vi) Confirming that the revaluation of assets have been properly disclosed in the Balance Sheet.

(vii) Verifying the adjustment made in the members' accounts in the Register of Members and confirming that either the paid up amount shown on the old share certificates have been altered or new certificates have been issued in lieu of the old, and the old ones have been cancelled.

(viii) Confirming that the words "and reduced", if required by the order of the Tribunal, have been added to the name of the company in the Balance Sheet.

(ix) Verifying that the Memorandum of Association of the company has been suitably altered.

8.5.13 (*a*) Verification of Forfeiture of Shares

The auditor should :

(i) ascertain that the Articles authorise the Board of Directors to forfeit shares and that the power has been exercised by the Board in the best interest of the company;

(ii) verify the amount of call or instalment of calls which was outstanding in respect of each of the share forfeited;

(iii) ascertain that the procedure in the Articles has been followed, viz., the notice given (14 days, according to Table A) to the defaulting shareholders, warning them that in the event of non-payment, by a specified date, of the amount of call already made on the shares standing in their names, together with interest, if any, the shares shall be forfeited; see that the proper resolutions of Directors, first as regards issuance of notice and afterwards in respect of forfeiture of shares; and

(iv) verify the entries recorded in the books of account consequent upon forfeiture of shares to confirm that the premium, if any, received on the issue of shares has not been transferred to the Forfeited Shares Account.

(b) Re-issue of Forfeited Shares

The auditor should :

(i) ascertain that the Board of Directors has the authority under the Articles to re-issue forfeited shares;

(ii) refer to the resolution of the Board of Directors, reallotting forfeited shares;

(iii) vouch the amounts collected from person to whom the shares have been allotted and verify the entries recorded from reallotment and see that the total amount received on the share, including that received prior to forfeiture, is not less than the par value; and

(iv) verify that computation of the amount of surplus resulting on the reissue of shares credited to the Capital Reserve Account; and

(v) where partly paid shares are forfeited for non-payment of call, and are re-issued as fully paid, the re-issue is treated as an allotment at a discount *Biochemical and Synthetic Products Ltd.* v. *Registrar of Companies* [(1962) 32 Comp. Case 654]. In such a case the provisions of Section 79 would require compliance.

8.6 OPTION ON SHARE CAPITAL

Schedule VI, Part I, requires disclosure of the particulars of any option on unissued share capital. An option on shares arises when a person has acquired a right under an agreement with the company to subscribe for share in the company if he so chooses. Such options generally arise under the following circumstances :

(i) Under the promoter's agreements, subsequently ratified by the company;

(ii) Collaboration agreement;

(iii) Loan agreements, debenture deeds (Refer to Section 81 of the Companies Act);

(iv) Agreements to convert preference shares into equity shares; and

(v) Other contracts, such as for supply of capital goods and/or merchandise.

8.7 SHARES TRANSFER AUDIT

Frequently, big companies require auditors to undertake audit of share transfer recorded by the company during the previous year. The object of such an audit is detection of mistakes in the registration of transfers which may have the effect of saddling the company with the liability for damages claimed by a shareholder on account of losses suffered in consequence thereof. The various steps which are considered necessary for carrying out such an audit are given below :

1. Ascertain whether notices were sent in every case to the transferors and, in case of joint-holders, to each of the holders and the objections, if any, raised by them were taken into consideration before the transfers were registered.

2. Verify that in the case of partly paid shares, where the application for registration was made by the transferor, a notice invariably was sent to the transferee and the transfer was registered only when "no objection" had been received from him, within two weeks from service of notice on him [Section 110(2)].

3. Scrutinise Transfer forms, noting specially :

   (a) that in every case, the application for transfer was made in the prescribed form and the prescribed authority (contemplated in Clause 1A of Section 108) had stamped the data on which it was presented to it; also that it was delivered to the company :

      (i) in case of 'quoted' shares before the Register of members were closed for the first time subsequent to the transfer within twelve months from the date of presentation of the application to the prescribed authority whichever is later;

      (ii) in any other case within two months from the date of such presentation;

   (b) that each transfer form is properly executed and bears the appropriate stamp duty;

   (c) that the name of the company is correctly stated on the form;

   (d) that where the consideration for transfer appears to be inadequate, an enquiry was made by the company for ascertaining the reasons therefore. (This is not necessary if the Transfer Form bears the seal of the Collector of Stamps);

   (e) that the alterations, if any, have been suitably initialed; and

   (f) that the name and address of the transferee have been recorded completely and fully for purposes of correspondence.

4. Compare the signature of each transferor Form with his signature on the original application for shares or on the Transfer Form (when shares were acquired on a transfer).

5. Ascertain that none of the transferees is disqualified from holding shares in the company.

6. Vouch the entries in the Share Transfer Journal by reference to the transfer forms, noting in each case :

   (a) the name of transferor;

   (b) the name and address of the transferee;

   (c) the number and class of shares transferred; and

   (d) the distinctive number, if any, of the Share Transfer.

   The Transfer Forms, after they have been checked, should be marked and the transferor's share certificate cancelled to prevent the same being presented once again in support of another transfer. The distinctive number of shares, if any, on the shares certificate surrendered, should be verified by reference to the distinctive numbers recorded in the member's Register.

In the case of a transfer registered in the absence of share certificate, the Letter of Indemnity or any other documentary evidence on the basis of which the transfer has been registered should be inspected.

7. Verify by reference to the Minute Book of the Board of Directors that all the transfer recorded in the Transfer Journal have been approved by the Board.

8. Confirm that every clerk who was entrusted with certain duties as regards the registration of transfers has initialed the documents verified by him.

9. Check the postings of distinctive numbers of shares transferred and the name of transferors and transferees into the Register of Members from the Share Transfer Journal.

10. Verify the particulars entered on counterfoils of shares certificate issued to the transferees in pursuance of the transfers registered by reference to Directors' Minute Book.

    In case where only a part of the shares have been transferred out of those mentioned in a Share Certificate, verify the issue of Balance Certificates to the transferor and confirm that the distinctive numbers of shares are correctly stated.

11. Verify that every duplicate Shares Certificate in lieu of the one lost or destroyed has been issued under the consent of the Board and on the conditions prescribed by the Board as regards production of evidence or execution of a Bond of Indemnity.

12. Ascertain, in cases where share certificates have been issued in replacement of old certificates, whether such a fact was entered on the face of the Certificate and also whether such a fact was entered on the stub of the counterfoil. Further, that in case of duplicate issued in lieu of the one lost or destroyed the undermentioned statement was entered on the duplicate Share Certificates and also stated on the stub of the counterfoil;

    "Duplicate issued in lieu of Share Certificate No. ....."

13. Confirm that in either of the above mentioned two cases, the word "Duplicate" was punched or stamped in bold letters across the face of the Share Certificate.

14. Trace the essential particulars from the counterfoils of the Share Certificate issued in lieu of those lost or destroyed into both the Register of Members and in the Register of Renewed or Duplicate Certificates.

15. Confirm that the forms of share certificates are printed only under the authority of the Board and that a person, appointed by the Board, is in custody of all he unused stock of Share Certificates, as well as, the blocks and other equipment employed for their printing and that the person appointed is responsible for rendering an account thereof.

Note : The Depositories Act, 1996 requires that nothing contained in section 108 relating to transfer shall apply to transfer of security effected by the transferor and transferee both of whom are entered as beneficial owners in the records of a depository.

Transmission - In the case of transmission of shares registered on the death or insolvency of a shareholder, the auditor should see :

(a) that the procedure prescribed by the Articles in this regard has been strictly followed.

(b) that in case of transmission on death of any executor the undermentioned documents relating to his authority for such a transfer were examined by the company:

  (i) the grant of probate or succession certificate of Power of Attorney; and

  (ii) a request from the executor that the shares be entered in his name. Ascertain that particulars of those documents are entered in a register specially maintained for the purpose; and

(*c*) that in the case of a transmission on insolvency, the order of the Court and any other document relevant thereto was examined; also refer to the Minutes of the Board of Directors approving the transmission.

Transmission of shares is generally governed by the provision contained in the Articles of Association. Section 109A inserted by the Companies (Amendment) Act, 1999 provides for the facility of nomination. The nominee can either be individual or a company. Section 109B accordingly deal with registration of nominee shareholder, his rights and duties.

General :

(i) Reconcile the amount of transfer fees collected with total number of transfers lodged and verify that the amounts of transfer fees have been accounted for.

(ii) Reconcile the total number of shares of different classes issued by the company with the total amount of capital issued and its sub-divisions by extracting balance of shares held by different members from the Member's Register.

(iii) Confirm that, in case of transfer registration whereof was refused, the notice of refusal was sent to the transferor and the transferee within a period of two months (Section 111).

  Further section 111A relating to rectification of register pursuant to the Depositories Act, 1996, contains relevant provision enabling the Tribunal to direct rectification of registers.

(iv) Confirm that, in case any shares held by Directors have been transferred by them, corresponding entries have been made in the Register of Director's shareholding.

(v) Confirm that if a company has refused to register the transfer of or the transmission by operation of law the right to any shares within 2 months from the date on which the

instrument of transfer or the intimation of such transmission was delivered to the company has sent notice of the refusal to the transferee and the transferor or the person giving intimation of such transmission as the case may be giving reasons for such refusal.

Note - Students should also refer to study material on Company Law for restrictions on transfer of shares. Further, it may be noted that sections 108A to 108G which intended to restrict acquisition and transfer of shares of or by companies shifted to the MRTP Act, 1969 have been transferred back to the Companies Act, 1956.

8.8 VERIFICATION OF ISSUE OF BONUS SHARES

Primarily, it should be ascertained whether the Articles permit capitalisation of profits; also whether the company had a sufficient number of unissued shares for allotment as

bonus shares. In addition, the following steps should be taken :

(a) Inspect the Minute book of Shareholders for the resolution authorising declaration of the Bonus and Director's Minute for the resolution appropriating profits for being applied in payment of shares to be allotted to shareholders as bonus shares;

(b) Trace the allotment of shares as per particulars contained in the Allotment Book or sheets into the Register of Members; and

(c) Confirm that all statutory requirements relevant to the issue of shares have been complied with, viz., the filing of the particulars of the bonus shares allotted with the Registrar together with a copy of the resolution pursuant to which allotment has been made.

(d) Confirm that the issue of fully paid up bonus shares in pursuance of sub-section (3) of Section 205 has been kept in abeyance in respect of shares where any instrument of transfer of such shares has been delivered to the company for registration and the transfer of such shares has not been registered by the company as required by the provisions of section 206A of the Companies (Amendment) Act, 1988.

(e) Ensure that SEBI Guidelines relating to issue of bonus shares have been complied with.

It has been stated earlier in this chapter that the balances in the Securities Premium Account and Capital Redemption Reserve Account, which are not available for distribution as dividend, can be utilised for allotment of fully paid bonus shares to the members and the balance in the above-mentioned account are usually first utilised for the purpose.

All applications for bonus issue have to be signed by a person not below the rank of a Director together with a certificate indicating that the information furnished is true and

correct and that all the data acquired in the application form and guidelines has been furnished.

8.9 AUDIT OF DEBENTURES

8.9.1 Allotment of Debentures

As in the case of shares, in the case of debentures also, it is necessary for the auditor to verify whether allotment was made having regard to the terms and conditions contained in the prospectus or the Statement in lieu of Prospectus. The Companies (Amendment) Act, 1988 has made it compulsory for every company intending to offer debentures to the public for subscription by the issue of a prospectus shall, before such issue, make an application to one or more recognised stock exchanges for permission for the debentures intending to be so offered to be dealt with in the stock exchange or each such stock exchange. The auditor also must ascertain that the directors, while issuing the debentures, had acted within their powers having regard to restrictions contained in Section 293 and any further restrictions which may be contained the Articles of Association. Section 117A has now made it compulsory for filing of Debenture Trust Deed and creation of Debenture Redemption Reserve as per section 117B. It is specified that Debenture Trust Deed shall be open for inspection and can be made available on payment. The creations of Debenture Redemption Reserve is compulsory and it is further specified that this amount cannot be utilised for any other purpose except for redemption of debentures. Section 117B has also made it compulsory appointment of debenture trustees and specified their duties.

The following are the steps that should be taken for such a verification :

(i) Verify that the Prospectus or the Statement in lieu of Prospectus had been duly filed with the Registrar before the date of allotment.

(ii) Check the applications for debentures with the Application and Allotment Book to verify that the name, address of the applicants and the number of debentures applied for are correctly recorded.

(iii) Verify the allotment of debentures by reference to the Directors' Minute Book.

(iv) Vouch the amounts collected as are entered in the Cash Book with the counterfoils of receipts issued to the applicants; also trace the amounts into the Application and Allotment Book.

(v) Check postings of allotments of debentures and the amounts received in respect thereof from the Application and Allotment Book, into the Debentures Register.

(vi) Verify the entries on the counterfoils of debentures issued with the Debentures Register.

(vii) Extract balances in the Debentures Register in respect of amounts paid by the debenture holders and agree their total with the balance in the Debentures Account in the General Ledger.

(viii) Examine a copy of the Debenture Trust Deed and note the conditions including creation of Debenture Redemption Reserve contained therein as to issue and repayment.

(ix) If the debentures are covered by a mortgage or charge, it should be verified that the charge has been correctly recorded in the Register of Mortgages and Charges and that it has also been registered with the Registrar of Companies. Further, that the charge is clearly disclosed in the Balance Sheet.

(x) Compliance with SEBI Guidelines should also be seen.

Where debentures have been issued as fully paid up to vendors as a part of the purchase consideration, the contract in this regard should be referred to.

8.9.2 Issue of Debentures

Debentures may be issued at par or at a premium or at a discount. When these are issued at a premium, the amount of premium collected should be credited to Premium on Debenture Account. Since it would be a capital profit, the balance to the credit of this account subsequently should be transferred to the Capital Reserve Account.

Where debentures have been issued at a discount, the amount of discount should be debited to Discount on Debenture Account so that the Debenture Account is credited with the full normal value of debentures. The balance in this account shall appear in the Balance Sheet until written off. Usually, the debentures will continue to stand in the books of the company. Where, however, the debentures are irredeemable, the amount of discount should be written off over a reasonable period of the time.

8.9.3 Redemption of Debentures at a Premium

The provision for the premium payable on redemption of debentures may be made in either of the following two ways :

(i) The total amount of premium payable on redemption may be debited to an account denominated as “Loss on Issue of Debentures” and credited to “Premium payable on Redemption of Debentures Account or subsequently, the debit balance in the first mentioned account should be carried forward till it is written off, while the latter account would be closed on payment of the premium, on redemption of debentures.

(ii) The fact that the debentures will have to be redeemed at a premium maybe disclosed by way of a note in the Balance Sheet along with the date of redemption and, as and when redemption is made, the amount paid as a premium should be debited to the Premium on Redemption of Debentures Accounts.

It may be noted that the second method is only a slight variation of the first in so far that, in the latter case, the premium paid on debentures is written off subsequent to the redemption.

8.9.4 Interest on Debentures

The payment of interest should be vouched with the acknowledgment of the debenture holders, endorsed warrants and in the case of bearer debentures, with the coupons surrendered. The total amount paid should be reconciled with the total amount due and payable with the amount of interest outstanding for payment. Interest on debentures is payable whether or not any profit is made. Therefore, a provision should be made unless it has been specially agreed with the debentureholders that interest in such a case would be waived by them. The interest paid on debentures, like that on other fixed loans, must be disclosed as a separate item in the Profit and Loss Account.

8.9.5 Re-issue of Redeemed Debentures

A company may issue debentures previously redeemed, either by reissuing the debentures or by issuing others in their place unless the Articles or a contract or resolution, recorded at a General Meeting, or terms of issue or some other act of the company expressly or impliedly manifest the intention that, on redemption, the debentures shall be canceled. However, the re-issue of redeemed debentures or the issue of others in their place are treated as a new issue for the purpose of stamp duty and the rights and privileges attaching to the debentures that re-issued shall be the same as if the debentures had never been redeemed. On these considerations, it is necessary for the auditor to verify the re-issue of debentures in the same manner as those issued for the first time.

8.9.6 Re-issue as Collateral Security

Quite frequently debenture are issued as collateral security to creditors, bankers or other parties. The nominal value of the debentures deposited as security generally exceeds the amounts of the loan by 10 or 20 per cent. In such a case, the liability of the company being limited to the amount of the loan and not the face value of the debentures which have been issued, only as a collateral (secondary or additional) security, the amount of

debentures is shown only in an inner column in the Balance Sheet. The collateral security becomes effective only in the event of default or the loan not being repaid when due. As soon as the loan is repaid, the debentures are automatically freed.

The auditor should ensure that the existence of the collateral security is disclosed against the liability concerned in the Balance Sheet. He should also examine the loan agreement and confirm that the issue has been approved by the Board of Directors and other formalities, as regards registration of the charge, etc., with the Registrar of Companies have been carried out.

8.10 AUDIT OF DIVIDENDS

8.10.1 Verification of Dividends

In Chapter-8 of PE-II study material on Accounting, the various conditions subject to which profits are earned by a company can be distributed as a dividend have been discussed. Therefore, only the procedure for the verification of payment of dividends is stated below :

1. Examine the company's Memorandum and Articles of Association to ascertain the dividend rights of different classes of shares.
2. Confirm that the profits appropriated for payment of dividend are distributable having regard to the provisions contained in Section 205 and that the transfer to reserves is according to rules framed by the Central Government in this respect [vide Section 205(2A)]. It may be noted that now there exists a requirement to transfer profits to reserves upon 10 per cent of the profits of that year. However, if the rate of dividend does not exceed 10 per cent no such transfer is necessary. If the company proposes to pay the dividend out of past profit in reserves, see that either this is in accordance with the rules framed by the Central Government in this behalf or the consent of the Government has been obtained. [vide Section 205A(3)].
3. Inspect the shareholders' Minute Book to verify the amount of dividend declared and confirm that the amount recommended by the directors.
4. If a separate bank account was opened for payment of dividends, check the transfer of the total amount of dividends payable from the Dividends Accounts.
5. Check the particulars of members as are entered in the Dividend Register or Dividend List by reference to the Register of Members, test check the calculation of the gross amount of dividend payable to each shareholder on the basis of the number of the shares

held and the amount deductible for income-tax. Verify the casts and crosscast of the different columns.

6. Check the amount of dividend paid with the dividend warrants surrendered. Reconcile the amount of dividend warrants outstanding with the balance in the Dividend Bank Account.

7. Examine the dividend warrants in respect of previous years, presented during the year for payment and verify that by their payment, any provision contained in the Articles in the matter of period of time during which amount of unclaimed dividend can be paid had not been contravened.

8. According to section 205A, as it is compulsory for a company to transfer the total amount of dividend which remains unpaid or unclaimed, within thirty days of the declaration of the dividend to a special bank account entitled "Unpaid Dividend Account of .... Company Limited/Company (Pvt.) Limited". Such an account is to be opened only in a scheduled bank. The transfer must be made within 7 days from the date of expiry of thirty days.

   The expression "dividend which remains unpaid" means any dividend the warrant in respect thereof has not been encashed or which has otherwise not been paid or claimed.

9. In case any money transferred to the unpaid dividend amount of a company remain unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred to Investor Education and Protection Fund established under section 205C of the Act.

8.10.2 Interim Dividends

A company may distribute part of its profits during the two annual general meetings. That means, a company may declare dividends before the close of the accounting year and finalisation of accounts. Regulation 86 of Table 'A' of Schedule I to the Companies Act, 1956, provided that the Board may from time to time pay to the members such interim dividend as appeared to be justified by the company. However, the definition of "dividend" has been amended by the Companies (Amendment) Act, 2000, whereby the interim dividend is part of dividends. With the further amendment of section 205, the interim dividend has been brought completely at par with "dividends" declared in the normal course since it has been specified that provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall also apply to any interim dividend. The amended provisions read as under:

(1A) The Board of directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

(1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend.

(1C) The provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as far as may be, also apply to any interim dividend.

Therefore, conditions and procedures laid down in section 205A, 205C, 206, 206A and 207 would have to be complied with while declaring interim dividends.

Right to dividend, Right Shares and Bonus Shares to be held in abeyance pending registration of transfers of shares - Section 206A inserted by the Companies (Amendment) Act, [1988] requires that where any instrument of transfer of shares has been delivered to any company for registration and a transfer of such shares has not been registered by the company, the company shall transfer the dividend in relation to such shares to the special account referred to in section 205A. Further the company shall also keep in abeyance and offer to right shares and any issue of fully paid up bonus shares in respect of such shares which have not been registered by the company. However, the company may transfer the dividend in case it has been authorised by the registered holder of such shares in writing to pay such dividend to the transferee specified in such instrument of transfer.

Penalty for failure to distribute dividend within the prescribed period, i.e., thirty day, has been made quite stiff by prescribing imprisonment for three year. Rupees one thousand everyday for which the default continues as also liability to pay simple interest at the rate of 18% p.a.

8.11 PRESENTATION OF FINANCIAL STATEMENTS *

Section 211 provides that every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall, subject to the provisions of the said section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government either generally or in any particular case. In preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading “Notes” at the end of that Part.

The profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year and shall, subject to as aforesaid, comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto.

* Adapted from Spicer and Pegler’s Practical Auditing by S.V. Ghatalia.

It is further provided that nothing contained in the above provisions shall apply to any insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of balance sheet or profit and loss account, as the case may be, has been specified in or under the Act governing such class of company.

However, if in the opinion of the Central Government it is necessary to grant exemption in the public interest, it may, by notification in the Official Gazette, exempt any class of companies from compliance with any of the requirements of Schedule VI, either unconditionally or subject to such conditions as may be specified in the Notification.

The Central Government is also empowered, either on the application of or with the consent of, the Board of directors of the company, by order, to modify in relation to that company any of the requirements of this Act as to matters to be stated in the company's balance sheet or profit and loss account, for the purpose of adapting them to the circumstances of the company.

For the purposes of section 211, any reference to a balance sheet or profit and loss account shall include any notes thereon or documents annexed thereto, giving information required by the Act, and allowed by the Act to be given in the form of such notes or documents, except where the context otherwise requires.

Schedule VI, which deals with the form of the balance sheet in Part I, with requirements as to the profit and loss account in Part II is discussed hereunder. Part III defines and interprets certain lessons while Part IV contains an abstract of the financial statements and a general business profile of the company.

PART I

FORM OF BALANCE SHEET

Part I, Schedule VI to the Companies Act, 1956, prescribes the form of balance sheet and the requirements relating thereto. It should be noted that in addition to the requirements of the body of the Form which sets out instructions relating to each item of the balance sheet, the requirements in the Notes at the end of the Form and the requirements of the Act, wherever applicable, should be complied with.

The information required to be given under any of the items or sub-items in the balance sheet should be furnished in a separate Schedule or Schedules to be annexed to and to form part of the balance sheet, if such information cannot be conveniently included in the

balance sheet itself. This procedure is recommended when the items to be dealt with are numerous [Note (*a*)].

The general practice is to state the figures rounded off correct to a rupee. Note (*b*) provides that Paise can also be given in addition to rupees, if so desired.

Note (*n*) requires that comparative figures should be given.

The comparative figures should relate to the corresponding period–the previous year, half year or quarter as the case may be. The comparative figures must be complied on the same basis as the figures of the current year, on the principle that only like can be compared with like. Wherever the comparative figures are recast or re-grouped to make them comparable it is recommended that a note should be put under the balance sheet to that effect.

(1) *Share Capital*

The Share Capital should be classified into :

(a) Authorised Capital.

(b) Issued Capital.

(c) Subscribed Capital.

Under "Authorised Capital", the various classes of shares should be distinguished and the particulars of the numbers of shares and the face value of shares for each class should be stated. The particulars of the different classes of preference shares should also be given. The Particulars of any option on unissued share capital have to be specified.

Under "Subscribed Capital", the following particulars should be given.

(i) The various classes of shares should be distinguished and particulars of the different classes of preference shares should be stated.

(ii) Number of shares.

(iii) Face value of shares.

(iv) Amount called up.

*Note (*c*)* requires that in the balance sheets of subsidiary companies the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated. However, the auditor is not required to certify the correctness of such shareholdings as certified by the management.

The number of shares allotted as fully paid up pursuant to a contract without payments being received in cash should be shown separately. Even in respect of such shares a separate mention must be made of the shares which are allotted as fully paid up by way of bonus shares. In case of bonus shares, the source from which such shares are issued, *e.g.,* capitalisation of profits or reserves or from Share Premium Account, should be specified.

The unpaid calls should be deducted from the Subscribed Capital and should be anlaysed as under:

(i) Due by directors.

(ii) Due by others.

The amount originally paid up on the forfeited shares should be added to the Subscribed Capital. Any capital profit on reissue of forfeited shares should be transferred to a Capital Reserve.

Under the item "Share Capital", it is necessary to disclose :

(i) In respect of Redeemable Preference shares, the terms of redemption or conversion together with the earliest date of redemption or conversion, and

(ii) the particulars of any option on unissued share capital.

It should be noted that Share Premium Account should not be shown under "Share Capital", as it is required to be shown under "Reserves and Surplus".

(2) *Reserves and Surplus*

This item should be classified as under :

1. Capital Reserves.
2. Capital Redemption Reserve.
3. Share Premium Account.
4. Other Reserves specifying the nature and amount of each Reserve.
5. Surplus.
6. Proposed additions to Reserves.
7. Sinking Funds.

Under each of the above specific heads, the balance as per last balance sheet, additions thereto and deductions therefrom should be stated.

The word "fund" in relation to any "Reserve" should be used only where such Reserve is specifically represented by earmarked investments.

In respect of the Share Premium Account, details of its utilisation in the manner provided in section 78 should be given in the year of utilisation [Note (*cc*)].

In respect of other reserves, the nature and the amount of each reserve should be specified.

Any debit balance in the Profit and Loss Account should be shown as a deduction from the uncommitted reserves, if any [Note (*h*)].

The expression "Uncommitted reserves', would not include reserves set apart for a specific purpose such as reserve for doubtful debts, investment, fluctuation reserve, etc.

Under "Surplus", the balance in the Profit and Loss Account after providing for proposed allocations, namely, Dividend, Bonus or allocations to Reserves should be shown.

While classifying the items between Reserves and Provisions regard must be had to the definitions of these items given in Part III, Schedule VI, and accordingly any provision in excess of the amount reasonably necessary should be classified as a reserve.

(3) *Secured Loans*

This item should be classified as follows :

1. Debentures.
2. Loans and Advances from Banks.
3. Loans and Advances from subsidiaries.
4. Other Loans and Advances.

The nature of the security should be specified in each case. The interest accrued and due on "Secured Loans" should be included under the appropriate sub-heads under the head "Secured Loans", but the interest accrued but not due on secured loans is required to be shown under "Current Liabilities".

The loans from directors and manager should be shown separately. Where loans have been guaranteed by managers and/or directors, a mention thereof should be made and the aggregate amount of such loans under each head should be shown separately.

In respect of debentures, the terms of redemption or conversion and the earlier date of redemption or conversion should be stated. The particulars of any redeemed debentures which the company has power to re-issue should be given [Note (*j*)].

In case where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company should be stated [Note (*k*)]. This information may be given under the head "Investments".

(4) *Unsecured Loans*

This item should be classified as follows :

1. Fixed Deposits.
2. Loans and Advances from subsidiaries.
3. Short Term Loans and Advances :
   (a) From Banks.
   (b) From Others.
4. Other Loans and Advances :
   (a) From Banks.
   (b) From Others.

Loans from directors and managers should be shown separately.

In respect of item Nos. 2, 3 and 4, where loans have been guaranteed by managers and/or directors, a mention thereof should be made and the aggregate amount of such loans under each head should also be disclosed.

The Short Term Loans will include those which are due for not more than one year as at the date of the Balance Sheet [Note (*d*)].

The interest accrued and due on unsecured loans should be shown under the appropriate sub-heads but the interest accrued but not due must be shown under "Current Liabilities".

(5) *Current Liabilities and Provisions*

Current Liabilities and Provisions are required to be grouped separately as under :

(A) CURRENT LIABILITIES
   1. Acceptances.
   2. Sundry Creditors.
      (i) Total outstanding dues of small scale industrial undertaking(s); and
      (ii) Total outstanding dues of creditors other than small scale industrial

undertaking(s).

3. Subsidiary Companies.
4. Advance payments and unexpired discounts for the portion for which value has still to be given, *e.g.,* in the case of the following classes of companies :

   Newspaper, Fire Insurance, Theatres, Clubs, Banking, Steamship Companies, etc.
5. Investor Education and Protection Fund shall be credited by the following amounts namely:
   (a) Unpaid dividend;
   (b) Unpaid application money received by the companies for allotment of securities and due for refund;
   (c) Unpaid Matured Deposits;
   (d) Unpaid Matured Debentures;
   (e) Interest accrued on (a) to (d) above.
6. Other Liabilities.
7. Interest accrued but not due on loans.

(B) PROVISIONS

8. Provision for Taxation.
9. Proposed Dividends.
10. For Contingencies.
11. For Provident Fund Scheme.
12. For Insurance, pension and similar staff benefit schemes.
13. Other provisions.

The items should be classified as "Provision" of "Liabilities" having regard to the definitions of these terms in Part III, Schedule VI.

According to Note (*p*), current accounts with directors and manager, whether they are in credit or debit, should be shown separately.

It should be noted that interest accrued but not due on loans, whether secured or unsecured, is required to be shown under "Current Liabilities".

The provision for taxation if in excess of the amount, which in the opinion of the directors, is reasonably necessary for the purpose, should be classified as a "Reserve".

The name(s) of the small scale industrial undertaking(s) to whom the company owe any sum together with interest outstanding for more than 30 days, are to be disclosed.

(6) *Contingent Liabilities*

Under the head "Contingent Liabilities", the items should be classified as under :

1. Claims against the company not acknowledged as debts.
2. The uncalled liability on shares partly paid.
3. Arrears of fixed cumulative dividends.
4. Estimated amount of contracts remaining to be executed on capital account and not provided for.
5. Other money for which the company is contingently liable.

In respect of arrears of fixed cumulative dividends, the following details should be given :

(i) the period for which the dividends are in arrears showing separately such arrears on each class of shares;

(ii) the amount should be stated before deduction of income-tax, but in the case of tax-free dividends the amount should be shown free of income-tax and the fact that it is so shown should be stated.

Under sub-head 5, the amount of guarantees given by the company on behalf of directors or other officers of the company should be stated and where practicable, the general nature and the amount of each such contingent liability, if material, should be specified. Examples of other contingent liabilities are:

(i) Liability on Bills of Exchange discounted but not maturing on the balance sheet date.

(ii) Liability in respect of suits pending in the Court.

(iii) Dispute in regard to bonus, etc.

(iv) Matters referred to arbitration.

(7) *Fixed Assets*

The fixed assets should be classified as far as possible as under:

(a) Goodwill.

(b) Land.

(c) Buildings.

(d) Leaseholds.

(e) Railway sidings.

(f) Plant and Machinery.

(g) Furniture and Fittings.

(h) Development of Property.

(i) Patents, trade-marks and designs.

(j) Livestock.

(k) Vehicles.

The items of fixed assets not enumerated above should be shown separately as far as possible. Under each head, the original cost, additions thereto and deductions therefrom during the year, should be shown.

The total amount of depreciation written off or provided upto the end of the year should be stated. The amount of depreciation written off or provided should be allocated under the different asset heads and should be deducted in arriving at the value of fixed assets. According to clause 7 of Part III, where in the opinion of the directors, the amount of depreciation written off or retained is in excess of the amount reasonably necessary, the excess should be treated as a 'Reserve' and not as a 'Provision'.

In respect of depreciation written off before the commencement of the Act, such bifurcation is not necessary.

In case of any fixed asset which has been acquired from a country outside India, the original cost is required to be changed in consequence of a change in the rate of exchange, if there has been increase or reduction in the liability as expressed in Indian currency, (*i*) for making payment towards the whole or part of the cost of the asset or, (*ii*) for repayment of the whole or a part of monies borrowed by the company in foreign currency. The details of such adjustment are given in the instructions.

In case where the original cost cannot be ascertained without unreasonable expense or delay, the valuation shown by the books should be given. Such valuation should be the net amount at which an asset stood in the company's books at the commencement of the Act, after deduction of the amounts previously provided or written off for depreciation or diminution in value. When any such asset is sold, the amount of sale-proceeds should be shown as deduction.

In case, where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation, should show the reduced figures, with the date of reduction, in place of the

original cost. Every balance sheet for five years subsequent to the date of reduction must also show the amount of the reduction made.

Similarly, where the value of assets is written up, every balance sheet subsequent to such writing up must show the increased figures and the date of the increase in place of the original cost. Every balance sheet for the five years subsequent to the date of writing up must also show the amount of increase made.

(8) *Investments*

This item should be classified as under :

1. Investments in Government or Trust securities.
2. Investment in shares, debentures or bonds.
3. Immovable properties.
4. Investments in the capital of partnership firms.
5. Balance of unutilised monies raised by issue.

Under item (2) above, investments in shares, debentures or bonds of subsidiary companies should be separately stated.

In respect of all investments in shares, there should be shown separately, shares, fully paid up and partly paid up and the different classes of shares should be distinguished.

The nature of investments should be disclosed and where the investments are earmarked, the fund which such investments represent should be stated.

In each case, the mode of valuation, *e.g.,* cost or market value should be stated.

The aggregate amount of a company's quoted investments together with the market value thereof and the aggregate amount of a company's unquoted investments should be shown separately.

The interest accrued on investments should be shown under the heading "current assets" and not under this head.

Section 372(10) provides that every investing company shall annex to each balance sheet prepared by it a statement showing the bodies corporate (indicating separately the bodies corporate in the same group) in the shares of which investments have been made by it (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each body corporate. However, in case of an investment

company, it is sufficient if the statement shows only the investments existing as on the date of the balance sheet.

It may be noted that Note (I) makes a provision for disclosure similar to the one required under section 372(10) but the said section does not apply to certain companies. However, Note (I) does not contain similar exceptions. Hence, it appears that Note (I) will apply to all companies except those mentioned in the Note (I) itself.

Note (I) requires that a statement of investments (whether shown under "investments" or under "current assets" as stock-in-trade) separately classifying trade investments and other investments should be annexed to the balance-sheet.

A "trade investment" means an investment by a company in the shares or debentures of another company, not being its subsidiary, for the purpose of promoting the trade or business of the first company.

The said statement should show the names of the bodies corporate, indicating separately the names of the bodies corporate under the same management in whose shares or debentures, investments have been made. The nature and extent of the investments so made in each body corporate should be given.

Such statement should include all investments whether existing or not, made subsequent to the date as at which the previous balance sheet was made out. In case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it will be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out.

In regard to the investments in the capital of partnership firms, the names of firms, with the names of all their partners, total capital and shares of each partner should be given in the statement annexed to the balance sheet.

Where the company's debentures are held by a nominee or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated. This disclosure will enable a shareholder to ascertain how much profit the company will make if the debentures purchased by the company were to be cancelled.

All UN-utilised monies out of the issue must be separately disclosed in the Balance Sheet of the Company indicating the form in which such unutilised funds have been invested.

(9) *Current Assets, Loans and Advances*

The items under this head are required to be classified into (A) Current Assets; and (B) Loans and Advances.

(A) CURRENT ASSETS :

(1) Interest accrued on Investments.

(2) Stores and spare parts.

(3) Loose Tools.

(4) Stock-in-trade.

(5) Work-in-Progress.

(6) Sundry debtors :

(a) debts outstanding for a period exceeding six months.

(b) Other debts;

Less : Provision.

(7A) Cash balance on hand.

(7B) Bank balances—

(a) with Scheduled Banks.

(b) with others.

All unutilised monies out of the issue must be separately disclosed in the Balance Sheet of the company indicating the form in which such unutilized funds have been invested.

In regard to interest accrued on investments, it should be noted that dividends declared by the subsidiary companies after the date of the balance sheet should not be included unless they are in respect of period which closed on or before the date of the balance sheet.

The current accounts with directors and manager, whether they are in credit or debit should be shown separately.

If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion should be stated. For compliance with this requirement, it will be necessary for the auditor to ascertain the opinion of the Board.

In respect of stores and spare parts, stock-in-trade and works-in-progress, the mode of valuation should be stated. In regard to loose tools, the mode of valuation is not required to be shown as usually they are re-valued every year. As regards stock-in-trade, the amount in respect of raw materials should be stated separately where practicable.

Note (*g*) requires that any reference to benefits expected from contracts to the extent that they are not executed should not be made in the balance sheet but should be made in the Board's report.

The amounts to be shown under sundry debtors, according to Note (*o*), should include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.

The provision in respect of bad and doubtful debts should be shown by way of deduction. Such provision should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such provision, if already created, should be shown under "Reserves and Surplus" on the liabilities side under a separate sub-head "Reserve for Doubtful or Bad Debts".

The sundry debtors should be classified as under :

(a) according to age;

(b) according to security and realisability;

(c) showing separately, debts due by persons connected with the management and others.

According to age, sundry debtors should be classified into :

(i) debts outstanding for a period exceeding six months;

(ii) other debts.

According to security and realisability, sundry debtors should be classified as under:—

(i) debts considered good and in respect of which the company is fully secured;

(ii) debts considered good for which the company holds no security other than the debtor's personal security; and

(iii) debts considered doubtful or bad.

The debts due from persons connected with the management and others should be classified as under :

(a) debts due by directors or other officers of the company or any of them either severally or jointly with any other person;

(b) debts due by firms in which any director is a partner;

(c) debts due by private companies in which any director is a director or a member;

(d) debts due from other companies under the same management [names of the companies should also be disclosed - *vide* section 370(IB].

By way of a note the maximum amount due by directors or other officers of the company at any time during the year should be stated.

The cash balance on hand and the bank balances should be shown separately. In respect of bank balances, balances with Schedule Banks and those with others are required to be shown separately. There should be separately shown balances lying with bankers on current accounts, call accounts and deposit accounts.

In respect of balances with other than Scheduled Banks, the balances lying with each such banker on different accounts and the maximum amount outstanding at any time during the year from each such banker should be disclosed. The nature of interest of a director and his relative in each of the bankers (other than Scheduled Banks) should be stated.

(B) LOANS AND ADVANCES :

(8) (a) Advances and Loans to subsidiaries.

(b) Advances and loans to partnership firms in which a company or any of its subsidiaries is a partner.

(9) Bills of Exchange.

(10) Advances recoverable in cash or in kind or for value to be received *e.g.,* Rates, Taxes, Insurance, etc.

(11) Balances with Customs, Port Trust etc. (Where payable on demand).

The provisions in regard to disclosure of information in respect of "sundry debtors" also apply to "loans and advances" and in addition Note (*i*) requires disclosure of information as follows:—

(a) amounts due from other companies under the same management with the names of the companies - vide section 370(IB); and

(b) the maximum amount due from every one of these at any time during the year.

(10) *Miscellaneous Expenditure*

The miscellaneous expenditure to the extent not written off or adjusted should be classified as follows :

(1) Preliminary expenses.

(2) Expenses including commission or brokerage on underwriting or subscription of shares or debentures.

(3) Discount allowed on the issue of shares or debentures.

(4) Interest paid out of capital during construction (also stating the rate of interest).

(5) Development expenditure not adjusted.

(6) Other items (specifying nature).

Profit and Loss Account

The debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any, should be shown separately under the item "Profit and Loss Account".

PART II

REQUIREMENTS AS TO PROFIT AND LOSS ACCOUNT

It is already observed that section 211 requires that profit and loss account of a company should give a true and fair view of the profit or loss of the company for the financial year and should comply with the requirements of Part II of Schedule VI, so far as they are applicable thereto.

The said requirements do not apply to insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of profit and loss account has been specified in or under the Act governing such class of company. The power of the Central Government to exempt any company from the above provisions has been already discussed.

The Act does not prescrib any form of profit and loss account but it merely gives the requirements in regard to the matters to be stated in the profit and loss account.

The requirements of the said Part II, apply in like manner to the income and expenditure account as they apply to a profit and loss account.

The general requirements in regard to the profit and loss account are as under :

1. The profit and loss account should be so made out as clearly so as to disclose the result of the working of the company during the period covered by the account.
2. It should disclose every material feature relating to the working results of the company's business.
3. It should also disclose clearly credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.
4. It should set out the various items relating to the income and expenditure of the company arranged under the most convenient heads.
5. The comparative figures relating to the corresponding previous period, whether a year, half year or a quarter, should be given in the profit and loss account. The comparative figures should be regrouped wherever necessary and in that case a note should be placed at the foot of the profit and loss account to that effect.
6. It should disclose in particular the information required by clause 3 of Part II and it should contain or give by way of a note information required by clauses 4, 4A, 4B, 4C and 4D.

Under clause 3, profit and loss account should disclose, in particular the following information in respect of the period covered by the account.

(I) Turnover

The aggregate amount for which sales are effected by the company, must be shown as the gross figure, giving the amount of sales in respect of each class of goods dealt with by the company, and indicating the quantities of such sales for each class separately. The turnover may be shown after making adjustments in respect of return of goods, trade discounts and allowances etc.

The following amounts should not be deducted from sales but should be shown separately:

(a) Commission paid to sole selling agents within the meaning of Section 294 of the Act.

(b) Commission paid to other selling agents.

(c) Brokerage and discount on sales, other than the usual trade discount. The usual trade discount according to standard accounting practice should be deducted from the sales but the particulars of any unusual trade discount should be separately disclosed.

(II) Stocks, Purchases, etc.

1. In the case of manufacturing companies the following information must be disclosed :

   (a) The value of raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up all important basic raw materials should be shown as separate items as far as possible. The intermediates or components procured from other, manufacturers may be grouped under suitable headings without mentioning the quantities, if their list is too large to be included in the break-up. All those raw material items which in value, individually, account for 10% or more of the total value of the raw material consumed shall be shown as separate and distinct items with value and quantities thereof in the break-up. The usual practice is to show the opening stock *plus* purchase of raw materials, *minus* the closing stock so as to show the amount of raw materials consumed.

   (b) The opening and closing stock of goods produced giving break-up in respect of each class of goods and indicating the quantities thereof.

2. In case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof should be stated.

3. In the case of companies rendering or supplying services, the gross income derived from services rendered or supplied should be stated.

4. In case of a company which falls under more than one of the categories mentioned in items 1, 2 and 3 above, it shall be sufficient compliance with the requirements, if the total amounts, in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative break up and the gross income from services rendered are shown.

   For the disclosure of above information the following points should be noted :

   (i) The quantities should be expressed in quantitative denominations for which raw materials, purchases, stocks, and the turnover are normally purchased or sold in the market as the case may be (Note 1).

   (ii) For the purposes of disclosure in respect of items 1, 2 and 4 above, the items for which the company is holding separate industrial licences should be treated as separate class of goods. In case where a company has more than one industrial licence for production of the same item at different places or for expansion, the item covered by all such licences shall be treated as one class. In case of trading companies, import items should be classified according to the classification adopted by the Controller of Imports and Exports in granting the import licences (Note 2).

(iii) All those items which in value individually account for 10% or more of the total value of the purchases, stocks, or turnover, as the case may be, are to be shown as separate and distinct items with quantities thereof in the break-up. In respect of items other than the above items, in giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities (Note 3).

5. In the case of concerns other than the above, the gross income derived under the different heads should be shown.

(III) Work-in-progress

In the case of all concerns having work-in-progress there should be shown :

1. The amounts for which such works have been completed at the commencement of the accounting period, and
2. the amounts for which such works have been completed at the end of the accounting period.

In the case of manufacturing concerns it is recommended that the opening and the closing stocks of semi-finished goods or the opening and the closing amount of work-in-progress, as the case may be, should be stated.

(IV) Provision for depreciation

The amount provided for depreciation, renewals or diminution in the value of fixed assets should be separately stated. It is suggested that the particulars of any obsolescence loss written off should be separately given.

Where such provision is not made by means of a depreciation charge, the method adopted for making such provision and the amount should be stated.

In case no provision is made for depreciation, the fact that no provision has been made should be stated.

The quantum of arrears of depreciation computed in accordance with section 205(2) of the Act should be disclosed by way of a note.

The provision for depreciation, in excess of the amount, which, in the opinion of the directors is reasonably necessary for the purpose, should be treated as a reserve and not as a provision. If there has been any change in the method of depreciation the effect of the change should be clearly stated by way of a note.

(V) Interest

The amount of interest on the company's debentures and loans for fixed periods should be separately stated.

There should be stated separately the amount of interest, if any, paid or payable to the managing director and the manager.

(VI) Provision for taxation

The amount of charge for Indian income-tax and other Indian taxation on profits should be shown separately.

Where practicable, with Indian income-tax there should be also stated any taxation imposed elsewhere to the extent of the relief, if any, from the Indian Income-tax.

Where practicable, a distinction should be made between income-tax and other taxation. Different types of taxes should be shown separately.

Any adjustment to the provision for taxation on determination of the actual liability should be adjusted through the profit and loss appropriation account and the difference, if material, should be clearly shown.

In cases where a company has made a profit during the year but no tax is payable on account of carry forward of loss, depreciation, etc. it is recommended that an appropriate note may be given explaining the reasons why provision for taxation has not been made.

(VII) Reserves for repayment of share capital or loans

The amounts reserved for :

1. Repayment of share capital; and
2. Repayment of loans are to be shown separately.

It is unusual for a company to make provision for repayment of share capital. However, in the case of redeemable preference shares it is possible that the terms of issue may require the company to reserve a part of the profit for ultimate redemption of such preference shares.

The reserve created for redemption of debentures should be separately shown.

(VIII) Reserves

The aggregate, if material, of any amounts set aside or proposed to be set aside to reserves must be separately shown. Such amounts should not include provisions made to meet any specific liability, contingency or commitment known to exist at the date as at

which the balance sheet is made out. For this purpose the distinction between "provision" and "reserve" should be borne in mind.

The aggregate, if material, of any amounts withdrawn from such reserves also must be separately shown.

(IX) Provisions

The aggregate, if material, of the amounts set aside to make provision for specific liabilities, contingencies or commitments should be separately shown.

The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required, should be separately stated.

Where additions to or withdrawals from reserves and provisions have been made during the year and such transfers affect the profit and loss account, the amounts involved, if material, must be shown separately in that account or by way of a note. Where, however, the additions or withdrawals are capital transactions, *e.g.,* a transfer to capital reserve of a capital profit, such transactions should either appear on the face of the balance sheet or in a statement or report annexed thereto. The source from which the increase has been derived or the manner in which the decrease has been applied must be shown clearly.

The amount of provision, in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, should be treated as a reserve and not as a provision.

A proper distinction must be made between provisions and liabilities. Only the amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy should be termed as a provision. The term "liability" includes all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(X) Other expenditure

The expenditure incurred on each of the following items should be shown separately:

1. Consumption of stores and spare parts: It is not necessary to disclose separately the opening stock, purchases and closing stock of stores and spare parts. It is suggested that where the sale of items are material, such amounts should be separately disclosed.
2. Power and fuel.
3. Rent - including rent for factory, office, godowns, etc.
4. Repairs to buildings.

5. Repairs to machinery: Where repairs to buildings or machinery have been carried out departmentally, it is recommended that the expenditure under various heads such as salaries and wages, stores, etc. should be allocated to repairs account and the expenses so allocated should also be indicated by way of a note under their respective heads.

6. (a) Salaries, wages and bonus including gratuity, compensation, etc.

   (b) Contribution to provident and other funds.

   (c) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve. If such expenditure is adjusted against any previous provision or reserve, such information should also be given in the balance sheet under the relevant provision or reserve account.

7. Insurance .

8. Rates and taxes, excluding taxes on income: This item will cover local taxes, property tax, water tax, vehicle tax, State sales-tax, Central sales-tax, etc. It is suggested that the amount of sales-tax should be separately shown.

9. Miscellaneous expenses: Any item under which the expenses exceed 1% of the total revenue of the company or rupees five thousand whichever is higher, should be shown as a separate and distinct item under an appropriate head in the profit and loss account. It should not be combined with any other item to be shown under "Miscellaneous Expenses".

(XI) Income from investments

The amount of income from :

Trade investments and other investments should be separately shown.

Other income by way of interest must be separately stated, specifying the nature of the income.

If the gross income is stated in respect of the above items, the amount of income-tax deducted must be separately shown.

(XII) Profits or losses etc.

1. The profits or losses on investments to the extent not adjusted from any previous provision or reserve should be shown separately. If the profits or losses on investments are adjusted against any previous provision or reserve such information should also be given in the balance sheet under the relevant provision or reserve such information should also be given in the balance sheet under the relevant provision or reserve account. The profits or losses earned or incurred on account of membership of a partnership firm should be shown separately.

2. Profits or losses, if material in amount, in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature should be shown separately.
3. Miscellaneous income.

It is recommended that where the amount of miscellaneous income is material in amount the nature of the income should be stated.

(XIII) Subsidiary companies

The amount of dividend from subsidiary companies and provisions for losses of subsidiary companies, should be separately stated. Note (*f*) under the form of balance sheet requires that dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of period which closed on or before the date of the balance sheet.

(XIV) Dividends

The aggregate amount of dividends paid and proposed should be stated separately. It should also be stated whether such amounts are subject to deduction of income-tax or not.

(XV) Basis of accounting

The amount by which any items shown in the profit and loss account are affected by any change in the basis of accounting, if material, should be disclosed. If there has been any change in the method of valuation of stock-in-trade or work-in-progress or in the basis of providing for depreciation or any change from the cash to the mercantile system of accounting, the effect should be clearly disclosed.

Clause 4, Part II, Schedule VI, requires that the profit and loss account should contain or give by way of a note detailed information in respect of payments provided or made during the financial year to :

1. Directors;
2. Managing directors; or
3. Manager.

The disclosure should be not only in respect of payments provided or made by the company but also by the subsidiaries of the company and any other person. Such information should be detailed as under :

1. Managerial remuneration under section 198 of the Act paid or payable during the financial year to the directors (including managing directors), or manager, if any.
2. Other allowances and commission including guarantee commission (details to be given).
3. Any other perquisites or benefits in cash or in kind (stating approximate money value where practicable).
4. Pensions, etc. :
   (a) Pensions
   (b) Gratuities
   (c) Payments from provident funds, in excess of own subscriptions and interest thereon.
   (d) Compensation for loss of office.
   (e) Consideration in connection with retirement from office.

It should be noted that section 221 casts a duty on the officer of the company and other persons to give particulars and information required to be given in the balance sheet or profit and loss account of a company. Such particulars and information should be furnished by them in as full a manner as possible whenever so required by the company's auditor.

Clause 4A requires that the profit and loss account should contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act together with relevant details of the calculation of the commissions payable by way of percentage of such profits to :

1. Directors;
2. Managing directors; or
3. Manager.

Clause 4B requires that the profit and loss account should contain, or give by way of a note, detailed information in regard to amounts paid to the auditor, whether as fees, expenses, or otherwise for services rendered :

(a) as auditor;

(b) as adviser, or in any other capacity, in respect of
   (i) taxation matters;
   (ii) company law matters;

(iii) management services; and

(c) in any other manner.

The Institute of Chartered Accounts of India has recommended that the disclosure be made under the following heads :

(1) Audit fee;

(2) Fee for tax representation;

(3) Fee for company law matters;

(4) Fee for management services;

(5) Fee for internal auditing;

(6) Expenses reimbursed to auditors;

(7) Other services.

Clause 4C requires that in the case of manufacturing companies, the profit and loss account shall also contain by way of a note, detailed quantitative information in respect of each class of goods manufactured, in regard to the following :

(a) licensed capacity (Where licence is in force) as on the last date of the year;

(b) the installed capacity as on the last date of the year; and

(c) the actual production in respect of the finished products meant for sale. In cases where semi-processed products are also sold, separate details thereof shall be given.

For the above purposes the items for which there are separate industrial licences shall be treated as separate classes of goods. In respect of an item where there is more than one industrial licence for production at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class.

Clause 4D requires that the profit and loss account shall also contain by way of a note the following information :

(a) value of imports calculated on C.I.F. basis during the financial year in respect of :

(i) raw materials;

(ii) components and spare parts;

(iii) Capital goods.

(b) expenditure in foreign currency during the year on account of royalty, know-how, professional consultation fees, interest, and other matters.

(c) the value of:

(i) all imported raw materials, spare parts and components consumed,

(ii) the value of all indigenous raw materials, spare parts and components consumed, and

(iii) the percentage of each item in (*i*) and (*ii*) above, to the total consumption.

(d) the amount remitted during the year in foreign currencies on account of dividends. A specific mention should be made of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends relate.

(e) earnings in foreign exchange classified as under :

(i) export of goods calculated on F.O.B. basis;

(ii) royalty, know-how, professional and consultation fees;

(iii) interest and dividend;

(iv) other income, indicating the nature thereof.

PART III

INTERPRETATION

(1) For the purposes of Parts I and II of this Schedule, unless the context otherwise requires:

(a) the expression 'provision' shall, subject to sub-clause (2) of this clause, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) the expression 'reserve' shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(c) the expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account and the expression 'revenue reserve' shall mean reserve other than a capital reserve; and in the sub-clause the expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(b) any amount retained by way of providing for any known liability; is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision.

8. For the purposes aforesaid, the expression 'quoted investment' means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, and the expression 'unquoted investment' shall be construed accordingly.

Note : Part IV to Schedule VI has not been reproduced

Self-Examination Questions

1. Mark the correct proposition :

(i) The auditor should study the Memorandum and Articles of Association to :

(a) see whether the transactions of the company are intra vires or not;

(b) see locations of the branches of the company;

(c) establish the name of the directors;

(d) see whether his appointment is valid;

(ii) The study of the Prospectus is necessary to :

(a) note the terms on which shares or debentures have been issued;

(b) compare actual performance with that indicated in the Prospectus;

(c) note the views expressed by experts;

(d) note the contents contracts.

(iii) Shareholders' minute book has to be studied for :

(a) approval of important contracts;

(b) sanction of political donations;

(c) appointment of important officers of the company;

(*d*) appropriation of profits.

2. (a) Discuss the circumstances in which Bonus shares can be issued by a company.
   (b) Enumerate the procedures to be followed.
   (c) Explanation the duties and functions of the Auditor's in relation to the above.
3. State the procedures an auditor should follow to verify the issue of share capital.
   (a) for cash.
   (b) for consideration other than cash.
4. How will you examine the following items while auditing the accounts of a limited company?
   (a) Redemption of Preference Shares.
   (b) Forfeiture of Shares.
5. State whether the under-mentioned statements are true of false. You are required to give reasons for your answers :
   (a) A special resolution is required to authorise the issue of shares at a discount.
   (b) Secret reserves strengthen the financial position of a company and hence have a statutory recognition under the Companies Act.
   (c) A Chartered Accountant is eligible for appointment as an auditor of a company of which he is a shareholder.
   (d) Providing for depreciation in case of companies is not compulsory if the company does not propose to distribute dividend.
   (e) The balance to the credit of share premium account can be used for redemption of redeemable preference shares.
   (f) The first auditor appointed by the Board of Directors can be removed by them at a subsequent meeting.
   (g) Surplus on re-issue of forfeited shares which is standing to the credit of the Forfeited Shares Account can be distributed as dividend.
6. Discuss the provisions concerning issue of debentures at a premium or at a discount and show how the same should be verified for audit purposes.
7. Explain the method of audit examination of redemption of debentures at premium.

8. How will a statutory auditor of a company deal with the following matters ?
   (i) The company has given a donation to political party,
   (ii) The audit report of a branch audited by a local firm of auditors contains some qualifications,
   (iii) The books and vouchers in respect of the first 3 months of the accounting period are in custody of the police in connection with a criminal investigation and could not be produced before the auditor; and
   (iv) The provision for depreciation has been made on the straight line method whereas in the past it used to be on the written down value method.

9. (a) Part II of Schedule VI to the Companies Act, 1956 requires disclosure of the amount, if material, by which any items whom in the profit and loss account are affected by any change in basis of accounting.

   Discuss the significance of the above requirement with two practical examples.

   (b) Indicate the requirements as to the disclosure of the Auditor's remuneration in the profit and loss account of a company.

10. State how an auditor should outline the programme suitable for a share transfer audit.

11. Briefly explain the requirements of Schedule VI to the Companies Act, 1956, in respect of the disclosure of the following items in the final accounts of a limited company :—
   (a) Sundry Debtors,
   (b) Reserves and Surplus,
   (c) Foreign Exchange Earnings,
   (d) Expenditure incurred in respect of salaries and perquisites of employees.

12. Outline the procedures an auditor of a limited company should follow to satisfy himself that all of his clients' liabilities, actual or contingent, as on the date of the balance sheet, are either provided for or otherwise disclosed.

13. Briefly explain the requirements of Schedule VI to the Companies Act, 1956, in respect of the disclosure of the following items in the Accounts of a limited company:
   (a) Fixed assets,
   (b) Stock-in-trade and sectors.

   Also state briefly what are the matters now to be included in the Auditors' Report, in respect of the above assets, in the case of manufacturing companies.

14. How would you deal with the following in the course of an audit of a limited company's accounts?
    (a) The purchase ledger contains a number of debit balance.
    (b) Sale of scrap has increased disproportionately as compared to past three years.
    (c) A security deposit of Rs. 5,000, received from cashier, has been used for payment to a supplier.
15. Suggest an internal control system regarding purchase of raw materials, stores, plant and machinery, equipment and other assets in a large manufacturing company and explain its significance in the context of Manufacturing and Other Companies. (AUDITOR'S REPORT) ORDER, 1975.
16. How would you value the following items while auditing the accounts of a limited company? State also how they will appear in the Balance Sheet.
    (a) Machinery received in approval but not yet accepted.
    (b) Goods sold under forward contract but not yet delivered.
    (c) Unquoted shares held as investment.
    (d) Contingent assets.
17. How would you value the following assets? Please also state how they are required to be shown in the Balance Sheet to comply with the requirements of Schedule VI, Part I of the Companies Act, 1956 :
    (a) Jointly owned Assets
    (b) 'Know-how' relating to plans and design of Plant & Machinery.
18. (a) What do you understand by the term "right shares"? What are the points you will consider at the time of examining the issue and allotment of "right shares"?
    (b) What is the meaning of "options on unissued share capital" of a company?
19. Mention four important items for which the auditor would refer to each of the following :—
    (i) Board's Meeting Minutes Book
    (ii) Shareholder's Meeting Minutes Book.
20. State the requirements of Section 227(4-A)/Schedule VI to the Companies Act, 1956 with regard to the following :—
    (i) Share Capital
    (ii) Raw Materials

(iii) Salaries and Wages

(iv) Provident Fund Dues.

21. Write short notes on :

(i) Issue of Shares at Premium.

(ii) Payment of Interest out of the Capital.

(iii) Reduction of Share Capital.

22. Mention three important items which the auditor would verify from each of the following :

(a) Memorandum of Association

(b) Articles of Association

(c) Prospectus.

23. A large company had incurred expenditure aggregating in Rs. 13,45,849 under various revenue heads during the construction period of company's new industrial unit. The company wants to capitalise this expenditure. As an auditor, would you agree in this accounting treatment? Discuss.

Multiple Choice Questions

1. Which of the following section of the Companies Act, 1956 contains provisions regarding sources of dividend ?

(a) Section 206

(b) Section 207

(c) Section 204

(d) Section 205

2. The following statements relate to divisible profits and dividends -

(i) Dividends cannot be declared out of capital receipts

(ii) Dividends can be declared out of capital profits under section 208 of the Companies Act,1956

(iii) The articles of the company should permit such declaration

(a) (ii) Only

(b) (i) and (iii)

(c) (iii) Only

3. Which of the following statement(s) is/are correct ? Unpaid dividend should be transferred to a special dividend account within .....days of declaration of dividend
   (a) Forty five days
   (b) One month
   (c) Thirty days
   (d) Two months
4. Which of the following statement is not true with regard to declaration and payment of interim dividend by a limited company ?
   (a) Dividend includes interim dividends
   (b) It can be declared only on the basis of audited interim financial statements
   (c) It should be paid only in cash
   (d) Provisions for depreciation for the current year till the end of interim period should be provided before declaring interim dividends
5. Every company must maintain proper books of account with respect to
   (i) Receipts, Payments, assets and liabilities
   (ii) Sales and purchases
   (iii) Receipts, payments, income, expenditure, assets and liabilities
   (a) Only (i)
   (b) Only (iii)
   (c) Only (ii)
   (d) Both (i) and (ii)
6. Which of the following statement is not true with regard to place of maintaining books of account ?
   (a) The books of account should be kept at the registered office of the company
   (b) The board of directors may decide to keep them at any place by passing a resolution
   (c) This place should be in India
   (d) The company must inform the auditor in writing about the change in address
7. The books of account should be preserved in good condition and retained for a period of —
   (a) Not less than eight years immediately preceding the current year
   (b) Not more than eight years immediately preceding the current year
   (c) At least ten years from the preceding current year
   (d) At least five years from immediately preceding current year

8. As per the requirements of section 210 of the Companies Act, the gap between date of profit and loss account and the date of AGM at which it is laid should not exceed —
   (a) Nine Months
   (b) Three months
   (c) Six months
   (d) Four months
9. Which section of the Companies Act, 1956 contain provisions with regard to form and contents of balance sheet and profit and loss account ?
   (a) Section 210
   (b) Section 211
   (c) Section 212
   (d) Section 209
10. Which of the following statement is not true with regard to issue of sweat equity shares ?
   (a) The provisions regarding sweat equity shares are contained in section 79A of the Act.
   (b) Sweat equity shares are of a class already issued
   (c) These are issued at a discount form market price
   (d) The company should pass an ordinary resolution in the general meeting to authorise its issue
11. Under section 77A, the company can buy-back its --
   (i) Own equity shares held by public
   (ii) Own preference shares
   (iii) Sweat equity shares
      (a) (i) Only
      (b) (ii) Only
      (c) Both (i) and (ii)
      (d) All of the above
12. Option on share capital is a right on --
   (a) Unmissed share capital
   (b) Subscribed share Capital
   (c) Paid-up share capital
   (d) Uncalled share capital

CHAPTER 9

SPECIAL AUDITS

Learning Objectives

After studying this chapter, you will be able to -

- Understand the procedures to be adopted for auditing of government audit, local bodies, NGO's.
- Gain knowledge on auditing procedure of a firm, small companies, charitable institutions, educational institutions, hospitals, clubs, cinema and hotels.
- Audit hire purchase and leasing companies accounts.

9.1 GOVERNMENT AUDIT

9.1.1 Background

Government Audit is as old as organised governments and has fairly long pedigree even in developing countries. The concept, content and scope of government audit have developed in tune with the political, social and economic development of the countries. It has also responded to the needs of the administration. It aims to ensure accountability of the executive in respect of public revenue and expenditure. Primarily, the Parliament and in case of States, the State legislatures control all government expenditure through insistence upon demand for grants. The main idea underlying this control is that no expenditure can be incurred unless it has been voted upon by the Parliament or State Legislatures and funds for every such expenditure must be provided from out of the Consolidated Fund of India or of the State. After the expenditure has been incurred and the accounts are closed, the Appropriation Accounts are prepared which are scrutinised by the Public Accounts Committee. Thus Parliamentary or Legislative control is exercised before spending and after the expenditure actually incurred.

Since independence there has been a tremendous spurt in governmental activities with the attendant increase in expenditure, revenue and capital, and in receipts and borrowings to match the expenditure. Government has entered the business field and government in business is not the same as government administering law and order and attending to regulatory functions. Independent India witnessed a steady growth of state

commercial enterprise. The change in the character of government and the complex nature of its activities, including regulatory functions in an international environment, called for a change in the nature and scope of audit. Audit has evolved from accountancy and regularity check to evaluation of the end results of the operations of government.

Initially, government auditing in India as elsewhere was primarily expenditure-oriented. Gradually, audit of receipts-tax and non-tax was taken up. With the rapid growth of public enterprises, another major area of specialisation, *i.e.,* commercial audit, came into being. There are also a large number of non-commercial autonomous bodies financed by government in diverse fields of development and of academic study and scientific or social research which are also required to be audited from the viewpoint of public accountability.

Government audit has not only adopted the basic essentials of auditing as known and practised in the profession to suit the requirements of governmental transactions but has also added new concepts, techniques and procedures to the audit profession. The U.N. Hand book on Government Auditing and Developing Countries define government auditing in a comprehensive manner which is as follows :

Government auditing is the objective, systematic, professional and independent examination of financial, administrative and other operations of a public entity made subsequently to their execution for the purpose of evaluating and verifying them, presenting a report containing explanatory comments on audit findings together with conclusions and recommendations for future actions by the responsible officials and in the case of examination of financial statements, expressing the appropriate professional opinion regarding the fairness of the presentation.

Government audit serves as a mechanism or process for public accounting of government funds. It also provides public accounting of the operational, management, programme and policy aspects of public administration as well as accountability of the officials administering them. Audit observations based on factual data collection also serve to highlight the lapses of the lower hierarchy, thus helping supervisory level officers to take corrective measures.

Government audit is neither equipped nor intended to function as an investigating agency, to pursue every irregularity or misdemeanour to its logical end. The main objective of audit is a combination of ensuring accountability of administration to legislature and functioning as an aid to administration. However, criticism of administrative actions wherever warranted is inherent in auditorial function. This has to be understood and appreciated in a proper spirit, as the criticism is made in a constructive spirit.

In India, the function of audit is discharged by the independent statutory authority of the Comptroller and Auditor General through the agency of the Indian Audit and Accounts

Department. Audit is a necessary function to ensure accountability of the executive to Parliament, and within the executive of the spending agencies to the sanctioning or controlling authorities. The purposes or objectives of audit need to been tested at the touchstone of public accountability. The Comptroller and Auditor General (C & AG), in the discharge of his functions, watches that the various authorities act in regard to financial matters in accordance with the Constitution and the laws made by Parliament, and conform to the rules or orders made thereunder.

9.1.2 Legal Framework and Comptroller & Auditor General

The Constitution of India contains specific provisions regarding the appointment, salary and duties and powers of the C & AG. The constitution guarantees the independence of the C & AG of India by prescribing that he shall be appointed by the President of India and shall not be removed from office except on the ground of proven mis-behaviour or incapacity. As in the case of a Judge of the Supreme Court, he can be removed only when each House of Parliament decides to do so by a majority of not less than 2/3rd of the members of the House present and voting. The Parliament is competent to make laws to determine salary and other conditions of service and they cannot be varied to his disadvantage after his appointment. The Constitution further provides that the conditions of service of person serving in the Indian Audit and Accounts Department and the administrative powers of the C & AG shall be determined by the President after consultation with him.

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 passed in pursuance of the provisions of the Constitution lays down a fixed tenure of the office prescribing that he shall be paid a salary which is equal to the salary of the Judge of the Supreme Court thereby further strengthening his independence.

Article 149 states that the C & AG shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law made by the Parliament. The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines these functions and powers in detail.

Article 150 of the Constitution provides that the accounts of the Union and of the States shall be kept in such form as the President may on the advice of the C & AG prescribed.

Article 151 requires that the reports of the C & AG relating to the accounts of the Union/State shall be submitted to the President/Governor who shall cause them to be laid before House of Parliament/State Legislature.

9.1.3 Comptroller and Auditor General's — Duties and Powers

The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 defines functions and powers in detail. The relevant provisions are discussed hereunder :—

Duties of the C & AG :

(i) *Compile and submit Accounts of Union and States* - The Comptroller and Auditor General shall be responsible for compiling the accounts of the Union and of each State from the initial and subsidiary accounts rendered to the audit and accounts offices under his control by treasuries, offices or departments responsible for the keeping of such account. The Comptroller and Auditor General shall, from the accounts compiled by him or [by the Government or any other person responsible in that behalf] prepare in each accounts (including, in the case of accounts compiled by him, appropriation accounts) showing under the respective heads the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly, and shall submit those accounts to the President or the Governor of a State or Administrator of the Union Territory having a Legislative Assembly, as the case may be, on or before such dates as he may, with the concurrence of the Government concerned, determine.

The C & AG Act of 1971 has provisions for relieving him of this responsibility to give information and render assistance to the Union and States : The Comptroller and Auditor General shall, in so far as the accounts, for the compilation or keeping of which he is responsible, enable him so to do, give to the Union Government, to the State Government or to the Governments of Union Territories having Legislative Assemblies, as the case may be, such information as they may, from time to time, require and render such assistance in the preparation of the annual financial statements as they may reasonably ask for.

(ii) *General Provisions Relating to Audit* - It shall be the duty of the Comptroller and Auditor General—

(a) to audit and report on all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

(b) to audit and report all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

(c) to audit and report on all trading, manufacturing profit and loss accounts and balance-sheets and other subsidiary accounts kept in any department of the Union or of a State.

(iii) *Audit of Receipts and Expenditure* - Where any body or authority is substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly, the Comptroller and Auditor General shall, subject to the provisions of any law for the time being in force applicable to the body or authority, as the case may be, audit all receipts and expenditure of that body or authority and to report on the receipts and expenditure audited by him.

Where the grant or loan to a body or authority from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly in a financial year is not less than rupees twenty-five lakhs and the amount of such grant or loan is not less than seventy-five per cent of the total expenditure of that body or authority, such body or authority shall be deemed, for this purpose to be substantially financed by such grants or loans as the case may be.

(iv) *Audit of Grants or Loans* - Where any grant or loan is given for any specific purpose from the Consolidated Fund of India or of any State or of any Union Territory having a Legislative Assembly to any authority or body, not being a foreign State or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfillment of the conditions subject to which such grants or loans were given and shall for this purpose have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

(v) *Audit of Receipts of Union or States* - It shall be the duty of the Comptroller and Auditor General to audit all receipts which are payable into the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit and report thereon.

(vi) *Audit of Accounts of Stores and Stock* - The Comptroller and Auditor General shall have authority to audit and report on the accounts of stores and stock kept in any office or department of the Union or of a State.

(vii) *Audit of Government Companies and Corporations* - The duties and powers of the Comptroller and Auditor General in relation to the audit of the accounts of government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 1956.

Powers of C & AG

The C & AG Act gives the following powers to the C & AG in connection with the performance of his duties :

(a) To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.

(b) To require that any accounts, books papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

(c) To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which it is his duty to prepare.

In carrying out the audit, the C & AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

9.1.4 Expenditure Audit

The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are :—

(i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.

(ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.

(iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.

(iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.

(v) that the various programmes, schemes and projects where large financial expenditure has been incurred or being run economically and are yielding results expected of them. Such an audit is termed as the *performance audit*.

Each of the above audits is discussed in detail in the following paragraphs.

1. Audit against Rules & Orders - Audit against rules and orders aims to ensure that the expenditure conforms to the relevant provisions of the Constitution and of the laws

and rules made thereunder. It also seeks to satisfy that the expenditure is in accordance with the financial rules, regulations and orders issued by a competent authority. These rules, regulations and orders against which regularity audit is conducted mainly fall under the following categories :

(i) Rules and orders regulating the powers to incur and sanction expenditure from the Consolidated Fund of India or of a State (and the Contingency Fund of India or of a State);

(ii) Rules and orders dealing with the mode of presentation of claims against government, withdrawing moneys from the Consolidated Fund, Contingency Fund and Public Accounts of the Government of the India and of the States, and in general the financial rules prescribing the detailed procedure to be followed by government servants in dealing with government transactions; and

(iii) Rules and orders regulating the conditions of service, pay and allowances, and pensions of government servants.

It is the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate authorities. The job of audit is to see that these rules, regulations and orders are applied properly by the subordinate authorities. It is, however, not the function of audit to prescribe what such rules, regulations and orders shall be. But, it is the function of audit to carry out examination of the various rules, regulations and orders issued by the executive authorities to see that :

(a) they are not inconsistent with any provisions of the Constitution or any laws made thereunder;

(b) they are consistent with the essential requirements of audit and accounts as determined by the C & AG;

(c) they do not come in conflict with the orders of, or rules made by, any higher authority; and

(d) in case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

Audit of expenditure against regularity is of a quasi-judicial type of work performed by the audit authorities. It involves interpretation of the Constitution, statutes, rules, regulations and orders. The final power of interpretation of these, however, does not vest with the C & AG.

2. Audit of sanctions: The auditor has to ensure that each item of expenditure is covered by a sanction, either general or special, of the competent authority. The audit of sanctions is directed both in respect of ensuring that the expenditure is properly covered by a sanction, and also to satisfy that the authority sanctioning it is competent for the

purpose by virtue of the powers vested in it by the provisions of the Constitution and of the law, rules or orders made thereunder, or by the rules of delegation of financial powers made by an authority competent to do so.

3. Audit against provision of funds - Audit against provision of funds aims at ascertaining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made.

4. Propriety audit - According to 'propriety audit', the auditors try to bring out cases of improper, avoidable, or infructuous expenditure even though the expenditure has been incurred in conformity with the existing rules and regulations. With the passage of time, it was felt that regularity audit alone was not sufficient to protect properly the public interest in the spending of money by the executive authorities. A transaction may satisfy all the requirements of regularity audit insofar as the various formalities regarding rules and regulations are concerned, but may still be highly wasteful. A building may be constructed for installing a telephone exchange but may not be used for the same purpose resulting in infructuous expenditure or a school building may be constructed but used after five years of its completion a case of avoidable expenditure.

Audit should, therefore, try to secure a reasonably high standard of public financial morality by looking into the wisdom, faithfulness and economy of transactions. These considerations have led to the evolution of audit against propriety which is now being combined by the audit authorities with their routine function of regularity audit. It is hard to frame any precise rules for regulating the course of audit against propriety. Such an objective of audit depends for its acceptance on its appeal to the common sense and straight logic of the auditors and of those whose financial transactions are subjected to propriety audit. However, some general principles have been laid down in the Audit Code, which have for long been recognised as standards of financial propriety. Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows :

1. The expenditure should not be *prima facie* more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
2. No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
3. Public moneys should not be utilised for the benefit of a particular person or section of the community unless :
   (i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

It may be stated that it is the responsibility of the executive departments to enforce economy in public expenditure. The function of audit is to bring to the notice of the proper authorities of wastefulness in public administration and cases of improper, avoidable and infructuous expenditure.

5. Performance audit - The scope of audit has been extended to cover efficiency, economy and effectiveness audit or performance audit, or full scope audit. Efficiency audit look into whether the various schemes/projects are executed and their operations conducted economically and whether they are yielding the results expected of them, *i.e.,* the relationship between goods and services produced and resources used to produce them; and examination aimed to find out the extent to which operations are carried out in an economical and efficient manner. Economy audit looks into whether government have acquired the financial, human and physical resources in an economical manner, and whether the sanctioning and spending authorities have observed economy. Effectiveness audit is an appraisal of the performance of programmes, schemes, projects with reference to the overall targeted objectives as well as efficiency of the means adopted for the attainment of the objectives. Efficiency-cum-performance audit, wherever used, is an objective examination of the financial and operational performance of an organisation, programme, authority or function and is oriented towards identifying opportunities for greater economy, and effectiveness. The procedure for conducting performance audit covers identification of topic, preliminary study, planning and execution of audit, and reporting. While the trend towards a comprehensive approach for conducting performance of full scope audit is visible, the coverage and depth of evaluation vary according to the statutory limitations, and the organisational constraints of C & AG.

9.1.5 Audit of Receipts

The audit of receipts is neither all pervasive or as old as audit of expenditure but has come to stay in some countries. Such an audit provides for checking; (*i*) whether all revenues or other debts due to government have been correctly assessed, realised and credit to government account by the designated authorities; (*ii*) whether adequate regulations and procedures have been framed by the department/agency concerned to secure an effective check on assessment, collection and proper allocation of cases; (*iii*) whether such regulations and procedures are actually being carried out; (*iv*) whether adequate checks are imposed to ensure the prompt detection and investigation of

irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud or wilful omission or negligence to levy or collect taxes or to issue refunds; and (*v*) review of systems and procedures to see that the internal procedures adequately secure correct and regular accounting of demands collection and refunds and pursuant of dues up to final settlement and to suggest improvement. The basic principle of audit of receipts is that it is more important to look at the general than on the particular, though individual cases of assessment, demand, collection, refund, etc. are important within the area of test check. A review of the judicial decisions taken by tax authorities is done to judge the effectiveness of the assessment procedure.

The extent and quantum of audit required to be done under each category of audit are determined by the C&AG. These are neither negotiable nor questioned. The prescribed extent and quantum of audit are structured in accordance with the design of test check, random sampling, general review, in-depth study of specified areas, etc. as may be warranted by the nature of transactions, its importance in the scheme of activities of a department and the totality of its transactions, the frequency of check and total plan of audit to be executed during a period. Institutional mechanism provides for primary check by the auditor, test check by the supervisor and control and direction by the group leader. Planning, executing and reporting of work is directed and monitored at middle and top levels of the audit hierarchy. There are built-in arrangements within the C&AG to ensure that the work assigned to each employee is carried out as prescribed. The audit is conducted both centrally where accounts and original vouchers are kept and locally where the drawing and disbursing functions are performed depending on the organisational and institutional arrangements obtaining.

9.1.6 Audit of Stores and Stocks

Audit of the accounts of stores and stocks has been developed as a part of expenditure audit with reference to the duties and responsibilities entrusted to C&AG. Audit is conducted to ascertain whether the Regulations governing purchase, receipt, and issue, custody, sale and stock taking of stores are well - devised and properly carried out. The aim is also to bring to the notice of the government any deficiencies in quantities of stores held or any defects in the system of control. The audit of purchase of stores is conducted in the same manner as audit of expenditure, namely, that these are properly sanctioned, made economical and in accordance with the Rules for purchase laid down by the competent authority. The auditor has to ensure that the prices paid are reasonable and are in agreement with those shown in the contract for the supply of stores, and that the certificates of quality and quantity are furnished by the inspecting and receiving units. Cases of uneconomical purchase of stores and losses attributable to defective or inferior quality of stores are specifically brought by the audit. Accounts of receipts, issues and balances are checked regarding accuracy, correctness and reasonableness of balances in

stocks with particular reference to the specified norms for level of consumption of stock holding. Any excess or idle stocks is specifically mentioned in the report and periodical verification of stock is also conducted to ensure their existence. When priced accounts are maintained, the auditor should see that the prices charged are reasonable and have been reviewed from time to time. The valuation of the stocks is seen carefully so that the value accounts tally with the physical accounts and that adjustment of profits or losses due to revaluation, stock taking or other causes is carried out.

9.1.7 Audit of Commercial Accounts

Public enterprises are required to maintaine commercial accounts and are generally classified under three categories :—

(a) departmental enterprises engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;

(b) statutory bodies, corporations, created by specific statutes mostly financed by government in the form of loans, grants, etc. and

(c) government companies set up under the Companies Act, 1956.

The audit of departmental concerns is undertaken in the same manner as any department of government where commercial accounts are kept. Audit of statutory bodies or corporations depends on the nature and type of the statute governing the bodies or corporations. Both financial and accounts audit are conducted by the C&AG, and where compilation of accounts is vested with the C&AG, functions, norms and standards of works usually followed by the professional auditors are adopted *mutatis mutandis.* Government companies have their own auditors under the statute appointed by C&AG. In addition, the C&AG conducts a supplementary test audit of the accounts, as well as periodical financial audit and appraisal of performance. The C&AG also issues direction to the company auditors for reporting on specific aspects of their audit work. These are reviewed, and condensed in the audit reports to the government/legislatures. C&AG has adopted the mechanism of an Audit Board-comprising of representatives of the audit and nominees of government including functional specialists to process reviews or appraisals on performance.

In the case of a Government company, the auditor of a Government company shall be appointed or reappointed by the Comptroller and Auditor General of India. The Comptroller and Auditor-General of India shall have power under section 619(3) of the Companies Act, 1956 as follows :

(a) to direct the manner in which the company's accounts shall be audited by the auditor and to give such auditor instructions in regard to any matter relating to the performance of his functions as such ;

(b) to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf; and for the purposes of such audit, to require information or additional information to be furnished to person or persons so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General may by general or special order, direct.

The auditor aforesaid shall submit a copy of his audit report to the Comptroller and Auditor-General of India who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit.

As stated above, in the case of a government company, audit is conducted by professional auditors appointed on the advice of the C&AG and the latter is authorised under section 619(4) of the Companies Act, 1956 to conduct supplementary or test audit.

The C & AG shall direct the manner in which the company's accounts shall be audited by the statutory auditors and give such auditors instructions in regard to any matter relating to the performance of his functions as such. The directions under section 619(3)(*a*) broadly covers the system of book-keeping and accounts, internal control etc.

The C & AG has power to conduct a supplementary or test audit of the company's accounts by such person as he may authorise in this behalf and for the purposes of such audit require information or additional information to be furnished to any person or persons so authorised on such matters by such person or persons and in such form as the C & AG may be general or special order, direct.

The statutory auditors shall submit a copy of their audit report to the C & AG who shall have a right to comment upon or supplement the audit report submitted by the statutory auditors in such manner as he may think fit. Section 217(3) of the Companies Act, 1956 impose a duty on the board of directors of a company to give to fullest information and explanations in the Directors' report regarding every reservation, qualification or adverse remarks contained in the auditors' report. The Board's remarks on the auditors' report are to be given as an addendum to the report and are to form part of the main body of the report as per section 217(*3*). In the absence of similar provisions requiring the company to give reply on the reservation made by the C & AG, the board of directors of such a company is not bound to give information or explanation in respect of such comments.

The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

9.1.8 Reporting Procedures

The effectiveness of an audit depends on reporting results to the proper authority so that appropriate action may be taken to rectify the irregularities or impropriety where possible or to prevent re-occurrence. The right as also the obligation to report on the results of audit findings is inherent to the institution of the Auditor General and is usually safeguarded in the Constitution and related enactments. Article 151 of the Indian Constitution enjoins that the C&AG shall report on the accounts of the Union and of each of the States to the President or the Governor concern and the letter shall cause the report to be laid before the legislatures. The reports should not only be presented to the legislatures but thereafter also publicised adequately in order to create a proper climate of public opinion for taking remedial action where necessary, on the findings of the Auditor General. This may also constitute a more effective safeguard in the future.

In India the reporting is factual and the conclusions are left to be drawn by the reader. This is presumably to ensure total objectivity. Nothing debars C&AG from making recommendations in the audit report but traditionally this has been left to be done by the Public Accounts Committee. The overall Indian position regarding reporting standards contained in instructions issued by the C&AG on the subject. Experience and professional judgment ultimately determines what is to be included in the audit reports. The auditor has to be a thorough professional and the audit reports have to be prepared with great skill for both the presentation and contents should compel readership.

In accordance with the duties laid down under the C&AG Act, 1971 and the reporting requirements under the constitution of India, the following reports are prepared each year on an average by the C&AG.

		No. of Reports
1.	Union Government	
	(a) Civil	1
	(b) Post & Telegraphs	1
	(c) Defence	1
	(d) Railways	1

(e)	Commercial	10
(f)	Receipts	2
		16

2. State Governments including Union Territories with Legislature

		No. of Reports
(a)	Civil	26
(b)	Receipts	16
(c)	Commercial	15
	Statutory Corporations	57

		No. of Reports
(a)	Union Government	8
(b)	State Governments (including Electricity Board, Road Transport Corporations and State Financial Corporations)	73

9.2 AUDIT OF LOCAL BODIES

9.2.1 Background

A municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services. The discussion in following paragraphs is based on an article "Audit of Municipal Administration" by R. Chandrasekharan.

By 1947, the year of independence of India, most of the urban and semi-urban areas had been constituted into municipalities of one kind or another. Among them were the premier corporations of Bombay, Chennai and Kolkata each with a special kind of constitutional structure, better financial resources and subject to less state control than other municipal bodies. The service which the local bodies had to render was restricted to education, public health, sanitation, medical relief, roads and a few public works. This was so because these bodies were considered to be inefficient and they lacked adequate

financial resources. These bodies derived their revenues from a number of sources – taxes on property, taxes on trade, taxes on persons; fees and licences, non-tax resources such as rent of land, houses, income from commercial undertakings; government grants, etc.

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees. The taxation powers of the corporations are confined to a few items and are of a generally compulsive nature; on the other hand the tax powers of the other types of urban local authorities cover a wider range, optional in nature and subject to a procedure for their imposition requiring the final sanction of the state governments. Municipal authorities are endowed with specific local functions covering (a) regulatory, (b) maintenance and (c) development activities.

Expenditure incurred by the municipalities and corporations can be broadly classified under the following heads: (a) general administration and revenue collection, (b) public health, (c) public safety, (d) education, (e) public works, and (f) others such as interest payments, etc.

Property taxes and octroi are the major sources of the municipal authorities; other municipal taxes are profession tax, non-mechanised vehicles tax, taxes on advertisements, taxes on animals and boats, tolls, show-tax, etc. Local bodies may receive different types of grants from the state administration as well. Broadly, the revenue grants are of three categories:

(a) *General purpose grants*: These are primarily intended to substantially bridge the gap between the needs and resources of the local bodies.

(b) *Specific purpose grants*: These grants which are tied to the provision of certain services or performance of certain tasks.

(c) *Statutory and compensatory grants*: These grants, under various enactments, are given to local bodies as compensation on account of loss of any revenue on taking over a tax by state government from local government.

9.2.2 Financial Administration

It would be imminent on the part of the auditor to understand financial administration of local bodies before embarking upon the audit. Some of the aspects are as under:

Budgetary Procedure: This is geared to subserve the twin considerations of financial accountability and control of expenditure. The main objective is to ensure that funds are raised and moneys are spent by the executive departments in accordance with the rules and regulations and within the limits of sanction and authorisation by the legislature or

council. Budget preparation is usually the occasion for determining the levels of taxation and rates and the ceilings on expenditure.

Municipal budget formats and heads of accounts vary from state to state. There are variations between the corporation and municipalities. One important feature of the municipal budgets is that there is no strict separation between revenue and capital items; usually there is a 'head' called extraordinary items which cover most of the capital transactions. There are, however, a number of special funds (e.g. roads) or in some cases separate budgets for specific municipal functions (e.g. education) or enterprise activities (e.g., water supply and sanitation, transport, electricity, etc.)

Expenditure Control: The system of financial control obtaining in the state and central government level is conditioned by the fact that there is a clear demarcation between the legislature and executive. The integration of legislation and executive powers in the municipal council makes it difficult for its executive to function as its inquisitorial body as well. Moreover the separation of executive powers and functions in municipal government cannot accommodate the existence of an independent finance officer responsible to the municipal council or its executive committee. This leaves the system of external audit by state government as the only instrument of controlling municipal expenditure.

Accounting System: Municipal accounting and budget format have been criticised as neither simple nor comprehensible, sometimes providing inadequate information and at other times a surfeit of information. Both these situations are not conducive to a proper system of management information.

9.2.3 Audit of Local Bodies

The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Bombay and a few others have powers to appoint their own auditors for regular external audit. The important objectives of audit are:

(a) reporting on the fairness of the content and presentation of financial statements;

(b) reporting upon the strengths and weaknesses of systems of financial control;

(c) reporting on the adherence to legal and/or administrative requirements;

(d) reporting upon whether value is being fully received on money spent; and

(e) detection and prevention of error, fraud and misuse of resources.

Audit is another method of financial control on local governments. This provision is coupled with the privilege of *ultra vires*. An action of the local authority if it is beyond

legal authority can result in 'surcharge' by audit. This procedure is a legacy of colonial days and even in England it is being resorted to less and less. This may well be because of the increasing competence of the local government authorities.

In addition to the external audit, it is also opined by the learned author that there should be a system of internal audit in all municipal institutions. Internal audit should be provided by the institutions' own staff. It should be performed on a continuous basis according to a well defined programme. The external auditor should be able to rely upon the work of the internal audit as forming part of a complete system of internal financial control. Where there is no internal audit, as may happen in the case of small or poorly staffed municipalities, the external auditor himself has to detailed checking. As described under government audit above, increasing attention is being given, to what is described as 'value for money' audit. This kind of audit focuses upon assessment of whether urban institutions are fulfilling their responsibilities with efficiency, economy and effectiveness (sometimes known as 'the three Es').

9.3 AUDIT OF NON-GOVERNMENTAL ORGANISATIONS (NGO'S)

9.3.1 Background

NGOs can be defined as non-profit making organisations which raise funds from members, donors or contributors apart from receiving donation of time, energy and skills for achieving their social objectives like imparting education, providing medical facilities, economic assistance to poor, managing disasters and emergent situations. Therefore, this definition of NGO would include religious organisations, voluntary health and welfare agencies, charitable organisations, hospitals, old age homes, research foundations etc. The scope of services rendered by NGOs is extremely wide and as such can not be covered in a small definition. Some examples of NGOs operating in India include Child Relief and You (CRY), NORAD, UNICEF, Godhuli, Vidya, Concern India Foundation., etc.

Non-Governmental Organisations are generally incorporated as societies under the Societies Registration Act, 1860 or as a trust under the India Trust Act, 1882, or under any other law corresponding to these Acts enforced in any part of India. NGOs can also be incorporated as a company under section 25 of the Companies Act, 1956. None of the above mentioned Act warrant a mandatory registration under them for an NGO. But if an NGO is created as a trust and trust relates to immovable property worth more than one hundred rupees, the provision of Section 17(1) of the Registration Act, 1908 read with Section 123 of the Transfer of Property Act, 1882 must be complied with and the registration of trust becomes mandatory. In some states, such as the states of Maharashtra and Gujarat, where Public Trusts Acts have been passed, such as the Bombay Public Trusts Act 1950, all charitable trusts have to be registered under these

specific Public Trusts Acts. Registration under the Income Tax Act, 1961 and the Foreign Contribution (Regulation) Act, 1976 would also be invoked in many cases.

NGOs registered under the Companies Act, 1956 must maintain their books of account under the accrual basis as required by the provisions of section 209(3)(b) of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 1956. The NGOs which are not registered under the Companies Act, 1956 are allowed to maintain accounts either an accrual basis or cash basis.

9.3.2 Sources and applications of funds

The main sources of funds include grants and donations, fund raising programmes, advertisements, fees from the members, technical assistance fees / fee for services rendered, subscriptions, gifts, sale of produce or publications, etc.

Donations and grants received in the nature of promoter's contribution are in the nature of capital receipts and shown as liabilities in the Balance Sheet of NGO. These may either be in the form of corpus contribution or a contribution towards revolving fund. A contribution made towards the capital or the corpus of an NGO is known as corpus contribution. The donors are generally required to specify whether the donation/grant given by him shall form part of the corpus of the NGO. Such contributions are generally given with reference to the total funds required by an NGO. Section 11(1)(d) of the Income Tax Act 1961 also states that income in the form of voluntary contributions made with a specific direction that they shall form part of the corpus of the trust or institution shall not be included in the computation to total income. The objective of a contribution or grant towards a Revolving Fund is to rotate the amount by giving temporary loans from the fund to other NGO or beneficiaries for their projects and then recover the loan so as to give temporary loans again and so on. However, any interest earned from the beneficiary on such temporary loans from the revolving fund could be either added back to the fund or credited to the Income and Expenditure Account depending on restrictions laid down by the authority providing the contribution (for the revolving fund) or by the rules and regulations laid down by the concerned NGO in this regard.

Donations and grants received for acquisition of specific fixed assets are those grants whose primary condition is that an NGO accepting them should purchase, construct or otherwise acquire the assets for which the grant is given.

Many a times NGOs receive contributions in kind. These contributions include assets such as land, buildings, vehicles, office equipment, etc. and articles related to programmes / projects such as food, books, building materials, clothes, beds, and raw material for training purposes, e.g., Wool, reeds, cloth, etc.

The areas of application of funds for an NGO include Establishment Costs, Office and Administrative Expenses, Maintenance Expenses, Programme / Project Expenses, Charity, Donations and Contributions given, etc.

9.3.3 Provisions Relating to Audit

The auditors of an NGO registered under the Societies Registration Act, 1860 (or under any law corresponding to this Act, in force in any part of India) or the Indian Trusts Act 1882 are normally appointed by the Management of the Society or Trust. The auditors of NGO registered under section 25 of the Companies Act, 1956 are appointed by the members of the company. Some of the statues such as the Companies Act, 1956, Foreign Contribution (Regulation) Act 1976, Income Tax Act 1961 required that the accounts of the NGO be audited and submitted to the prescribed authorities and failure to do so could lead to forfeiture of certain exemptions and benefits. In the case of NGO/PDA's different statutes have specified certain audit reports. The Foreign Contribution (Regulation) Act 1976 has prescribed the format and requires that the same be furnished to the Ministry of Home Affairs within 60 days from the close of the financial year i.e. by May 30 each year.

While planning the audit, the auditor may concentrate on the following:

(i) Knowledge of the NGO's work, its mission and vision, areas of operations and environment in which it operate.

(ii) Updating knowledge of relevant statutes especially with regard to recent amendments, circulars, judicial decisions viz. Foreign Contribution (Regulation) Act 1976, Societies Registration Act, 1860, Income Tax Act 1961 etc. and the Rules related to the statutes.

(iii) Reviewing the legal form of the Organisation and its Memorandum of Association, Articles of Association, Rules and Regulations.

(iv) Reviewing the NGO's Organisation chart, then Financial and Administrative Manuals, Project and Programme Guidelines, Funding Agencies Requirements and formats, budgetary policies if any.

(v) Examination of minutes of the Board/Managing Committee/Governing Body/Management and Committees thereof to ascertain the impact of any decisions on the financial records.

(vi) Study the accounting system, procedures, internal controls and internal checks existing for the NGO and verify their applicability.

(vii) Setting of materiality levels for audit purposes.

(viii) The nature and timing of reports or other communications.

(ix) The involvement of experts and their reports.

(x) Review the previous year's Audit Report.

The audit programme should include in a sequential order all assets, liabilities, income and expenditure ensuring that no material item is omitted.

(i) *Corpus Fund*: The contributions / grants received towards corpus be vouched with special reference to the letters from the donor(s). The interest income be checked with Investment Register and Physical Investments in hand.

(ii) *Reserves*: Vouch transfers from projects / programmes with donors letters and board resolutions of NGO. Also check transfer of gross value of asset sold from capital reserve to general reserve and adjustments during the year.

(iii) *Ear-marked Funds*: Check requirements of donors institutions, board resolution of NGO, rules and regulations of the schemes of the ear-marked funds.

(iv) *Project / Agency Balances*: Vouch disbursements and expenditure as per agreements with donors for each of the balances.

(v) *Loans*: Vouch loans with loan agreements, receipt counter-foil issued.

(vi) *Fixed Assets*: Vouch all acquisitions / sale or disposal of assets including depreciation and the authorisations for the same. Also check donor's letters/agreements for the grant. In the case of immovable property check title, etc.

(vii) *Investments*: Check Investment Register and the investments physically ensuring that investments are in the name of the NGO. Verify further investments and dis-investments for approval by the appropriate authority and reference in the bank accounts for the principal amount and interest.

(viii) *Cash in Hand*: Physically verify the cash in hand and imprest balances, at the close of the year and whether it tallies with the books of account.

(ix) *Bank Balance*: Check the bank reconciliation statements and ascertain details for old outstanding and unadjusted amounts.

(x) *Stock in Hand*: Verify stock in hand and obtain certificate from the management for the quantities and valuation of the same.

(xi) *Programme and Project Expenses*: Verify agreement with donor/contributor(s) supporting the particular programme or project to ascertain the conditions with respect to undertaking the programme / project and accordingly, in the case of programmes/projects involving contracts, ensure that income tax is deducted, deposited and returns filed and verify the terms of the contract.

(xii) *Establishment Expenses*: Verify that provident fund, life insurance premium, employees state insurance and their administrative charges are deducted, contributed and deposited within the prescribed time. Also check other office and administrative expenses such as postage, stationery, travelling, etc.

The receipt of income of NGO may be checked on the following lines:

(i) *Contributions and Grants for projects and programmes*: Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.

(ii) *Receipts from fund raising programmes*: Verify in detail the internal control system and ascertain who are the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.

(iii) *Membership Fees*: Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.

(iv) *Subscriptions*: Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.

(v) *Interest and Dividends*: Check the interest and dividends received and receivable with investments held during the year.

9.4 MISCELLANEOUS AUDITS

9.4.1 Audit of a Sole Trader

A sole trader is under no legal obligation to have his accounts audited. However, many such individuals get their financial statement audited due to regulatory requirements, such as stock brokers or on a specific instructions of the bank for approval of loans, etc. As such, he can determine the scope of the audit as well as the conditions under which it will be carried out. For example, he can stipulate that only a partial audit shall be carried out, that certain parts of the accounts shall not be checked or that the auditor also shall prepare the final statements of account. He can also decide whether the audit shall be carried out continuously or at the end of the year.

On these considerations, it is desirable that the contract of appointment of auditor in such a case should be in writing; also that it should clearly define the scope of the work which the auditor is expected to carry out. This helps to prevent misunderstanding. If the appointment of the auditor is not in writing, the auditor should write to his client explaining

the scope of his duties. While doing so, he should state the limitations, if any, placed upon his work to obtain the client's confirmation.

The advantages discussed in following paragraphs of audit in case of a sole trader are much the same as those in the case of a partnership.

9.4.2 Audit of a Firm

The auditor to a firm is usually appointed by the partners either on the basis of a decision taken by them or to comply with a condition in the partnership agreement. His remuneration is also fixed by the partners. It is important that the letter of appointment should clearly state the nature and scope of audit which is to be carried out and particulars of limitations, if any, under which he would have to function.

The Indian Partnership Act, 1932 does not prescribe audit of a partnership firm. Nevertheless, for the verification of adjustment in the accounts of partners made in respect of profits and losses, interest and remuneration of partners, their contribution to capital, etc. It is necessary that the auditor should have a knowledge of the provisions in this regard under the Act—especially that of powers and audit of partners and their right to profit and capital under different situations and circumstances. The auditor may, particularly, ensure application of accounting standards prescribed by the Institute. In case the firm is required to get its accounts audited under the requirements of any statute, the auditor will have to qualify the report in case of non-compliance with the accounting standards. Alternatively, only disclosure of non-compliance with the accounting standards, would be sufficient without making it a subject matter of qualification. Also, before starting the audit, he should examine the partnership agreement and note the provisions therein as regards the following matters :

(1) The name and style under which the business shall be conducted.

(2) The duration of the partnership, if any, that has been agreed upon.

(3) The amount of capital that shall be contributed by each partner—whether it will be fixed or could be varied from year to year.

(4) The period at the end of which the accounts of the partnership will be closed periodically and the proportions in which the profit shall be divided among the partners or losses shall have to be contributed by them; whether the losses shall be borne by the partners or whether any of the partners will not be required to do so.

(5) The provisions as regards maintenance of books of account and the matters which must be taken into account for determining the profits of the firm available for division among the partners *e.g.*, creation of reserves, provision for depreciation, etc. also the period within which accounts can be reopened for correcting a manifest error.

(6) Borrowing capacity of the partnership (when it is not implied as in the case of non-trading firms).

(7) The rate at which interest will be allowed on the capitals and loans provided by partners and the rate at which it will be charged on their drawings and current accounts.

(8) Whether any salaries are payable to the partners or withdrawals are permitted against shares of profits and, if so, to what extent ?

(9) Duties of the partners as regards the management of business of the firm; also, the partners who shall act as managing partners.

(10) Who shall operate the bank account of the firm ? How will the surplus funds of the partnership be invested ?

(11) Limitations and restrictions that have been agreed upon the rights and powers of partners and on their implied authority to pledge the firm's credit or to render it liable.

In the absence of a partnership agreement, the provisions of the Act which concern the auditor are the following :

(i) Each partner is required to contribute an equal amount of capital.

(ii) The partners share equally in profits and losses.

(iii) The partners are not entitled to any interest on capital.

(iv) Where a partner is entitled to interest on the capital subscribed by him, such interest will be payable only out of profits.

(v) A partner is entitled to interest at 6 per cent per annum on his advances and loans over and above the capital.

(vi) Every partner can take part in the management of the business. A partner is, however, not entitled to receive any remuneration for taking part in the conduct of the business.

(vii) Every partner has the right to inspect and to take a copy of any of the books of the firm.

(viii) A partner is entitled to be indemnified for all payments made and liabilities incurred by him in the ordinary course of business or in the preservation of the firm's property.

(ix) The property of the firm must be held and used by the partners exclusively for the purpose of business.

(x) If a partner derives any profit for himself from any transaction of the firm or from the use of the property or business connections of the firm or the firm name, he must account for that profit and pay it to the firm; also the profit from any competing business carried on by a partner without other partners' consent must also be accounted for and paid to the firm.

(xi) In the absence of any usage or custom of trade to the contrary, the implied authority of partner does not empower him to :

(a) submit a dispute relating to the business of the firm to arbitration;

(b) open a bank account on behalf of the firm in his own name;

(c) compromise or relinquish any claim or portion of a claim by the firm;

(d) withdraw a suit or proceeding filed on behalf of the firm;

(e) admit any liability in a suit or proceeding against the firm;

(f) acquire immovable property on behalf of the firm;

(g) transfer immovable property belonging to the firm; or

(h) enter into partnership on behalf of the firm.

(xii) The firm is liable to third parties :

(a) if a partner, acting within the scope of his apparent authority, receives money and misapplies it, or

(b) if the firm in the ordinary course of the business receives money, which is misapplied by a partner.

(xiii) No person can be introduced as a partner without the consent of the other partners.

(xiv) Any differences arising as to ordinary matters connected with the business are to be decided by the majority of the partners, but no change can be made in the nature of the business without the consent of all the partners.

(xv) If, on the death or retirement of a partner, no final settlement has been effected and the business is carried on by the surviving or continuing partners, the outgoing partner or his estate has the option of claiming :

(a) such share of profits as may be attributable to his share of the assets; or

(b) interest at 6 per cent per annum on his share of partnership assets.

(xvi) On dissolution of the partnership, every partner has the right to have the goodwill of the business sold for the common benefit of all the partners.

(xvii) On a dissolution of the firm, the losses, including deficiencies of capital must be made good :

(a) first out of profits;

(b) next out of capital; and

(c) lastly, by the partners individually in the proportion in which they share profits.

(xviii) On the dissolution of the firm, assets are to be applied in the following order :

(a) in paying the firm's liabilities to third parties;

(b) in repaying partner's advances and loans;

(c) in repaying partner's capital; and

(d) the residue if any, is to be divided amongst the partners in the proportion in which they share profits.

Advantages - On broad considerations, the advantages of audit of accounts of a partnership could be stated as follows :

(1) Audited accounts provide a convenient and reliable means of settling accounts between the partners and, thereby, the possibility of occurrence of a dispute among them is mitigated. On this consideration, it is usually provided in and accepted by the partners, shall be binding upon them, unless some manifest error is brought to light within a specified period subsequent to the accounts having been signed.

(2) On the retirement or death of a partner, audited accounts, which have been accepted by the partners constitute a reliable evidence for computing the amounts due to the retiring partner or to the representative of the deceased partner in respect of his share of capital, profits and goodwill.

(3) The accounts of a partnership, which have been audited, are generally accepted by the Income Tax Department as the basis for computing the assessable income of the partners and also for the settlement of their liability in respect of Wealth Tax.

(4) Audited statement of accounts are relied upon by the banks when advancing loans, as well as by prospective purchasers of the business, as evidence of the profitability of the concern and its financial position.

(5) Audited statements of account can be helpful in the negotiations to admit a person as a partner, especially when they are available for a number of past years.

(6) An audit is an effective safeguard against any undue advantage being taken by a working partner or partners especially in the case of those partners who are not actively associated with the working of the firm.

Matters which should be specially considered in the audit of accounts of a partnership:

(i) Confirming that the letter of appointment, signed by a partner, duly authorised, clearly states the nature and scope of audit contemplated by the partners, specially the limitation, if any, under which the auditor shall have to function.

(ii) Studying the minute book, if any, maintained to record the policy decision taken by partners specially the minutes relating to authorisation of extraordinary and capital expenditure, raising of loans; purchase of assets extraordinary contracts entered into and other such matters as are not of a routine nature.

(iii) Verifying that the business in which the partnership is engaged is authorised by the partnership agreement; or by any extension or modification thereof agreed to subsequently.

(iv) Examining whether books of account appear to be reasonable and are considered adequate in relation to the nature of the business of the partnership.

(v) Verifying generally that the interest of no partner has suffered prejudicially by an activity engaged in by the partnership which, it was not authorised to do under the partnership deed or by any violation of a provision in the partnership agreements.

(vi) Confirming that a provision for the firm's tax payable by the partnership has been made in the accounts before arriving at the amount of profit divisible among the partners.

(vii) Verifying that the profits and losses have been divided among the partners in their agreed profit-sharing ratio.

From the foregoing steps involved in the audit of a partnership it would be observed that like the audit of every other commercial undertaking, it culminates in the verification of the Balance Sheet and the Profit and Loss Account to ensure that these exhibit a true and fair state of affairs of the firm.

The object of examining the partnership agreement, which is an important feature of such an audit, is that the auditor may be able to report to the partners if the interest of any partner has been prejudicially affected, on account of the firm having engaged itself in an activity which it was not authorised to do or violation of any provision of the partnership agreement.

Reports on accounts of sole traders and partnerships

There is no statutory form of auditor's report in the case of sole traders and partnerships. Often the auditors of sole traders and firms have nothing to say on the audited accounts except "Audited and found correct" or "Examined and found correct". This form of reporting is not recommended as it gives no indication of the extent of the examination of accounts that has been carried out.

The Guidance Note on Members' Duties regarding Engagements involving Compilation of Financial Statements to provide guidance on the professional responsibilities of the members of the Institute of Chartered Accountants of India, when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report issued in connection with such a compilation so that the association

of the name of the member with the financial statements is not misconstrued by a user of the statements as the same having been audited by him.

For the member, the objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information, This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. However, users of the compiled financial information derive some benefit as a result of the member's involvement because the service has been performed with professional competence and due care.

A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarisation of other financial information. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, on the selection of an appropriate accounting policy) do not constitute an engagement to compile financial information.

It is essential that the member clearly brings out the nature of association with the financial statements and the nature of the work performed by him. The following recommendations are made in this regard

(i) The title of the report should be "ACCOUNTANT'S REPORT ON UNAUDITED FINANCIAL STATEMENTS "AND NOT AN 'AUDITOR'S REPORT".

(ii) The report should be addressed to the appointing authority.

(iii) The report should identify the financial information compiled, also stating that it is based on the information provided by the management.

(iv) The report should clearly state that the financial statements are not audited.

(v) In describing the engagement, ambiguous terms such as 'review', 'general review', 'check' etc., should not be used.

(vi) Date of the report should be mentioned.

(vii) Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.

(viii) Signatures and the designation (sole proprietor/partner) and membership number should appear in the report.

An example of the report is given below:

Example of an Accountant's Report on Unaudited Financial Statements

To.....

On the basis of information provided by management we have compiled the balance sheet of ..... *(name of the entity)* as of March 31, XXXX and the statement of profit and loss for the period then ended. The balance sheet and the statement of profit and loss are in agreement with the books of account. We have not audited or reviewed these financial statements and accordingly express no opinion thereon.

Date:

For A & Co.
Signature (Name of the partner and membership number)
Partner
Chartered Accountants

9.4.3 Audit of Small Companies

The duties and responsibilities of the auditors in respect of the individual small company client are the same as in larger audits and the satisfactory accomplishment of the work requires the skilful adaptation and application of the principles of auditing to the individual case. Because the relationship with the directors is frequently less formal, it is particularly important that the arrangement and scope of the work should be clearly defined and recorded. A number of problems relating to small companies and procedural matters of importance in this respect are, therefore, given in the following paragraphs :

(1) *Letter of Engagement* - It is advisable for the auditor to submit to their client and to receive an acknowledgement of the precise scope of their responsibilities both in respect of the audit and any additional work to be undertaken. At the time of engagement, the auditors should explain to the directors management's responsibilities for the preparation of the accounts and establishing a system of internal control appropriate to the needs of the business. The letter should also explain the reliance which the auditors can place upon an effective system. This should subsequently be confirmed in writing, possibly in the engagement letter.

(2) *Internal control* - At an early stage in the audit, the auditors should take care to bring to the directors' attention their findings on the system of internal control.

Problems in small companies arise in the application of auditing principles and procedures. Due to inadequate staff they are unable to apply these principles in totality. These problems mainly arise from :

(a) substantial domination of the accounting and financial functions by one person; and

(b) limitations in the effectiveness from the audit point of view of the system of internal control rendered inevitable by the small number of employees.

Either or both of the above points can be present to a significant extent in most of the small companies.

The major difference from the audit point of view between the small company and the large company will be the extent to which the system of internal control and staff organisation provide a check on the work of one person so that it is proved independently by or is complementary to the work of another. Whilst internal control and internal check in a small company may be effective for its primary purpose as a check for management use, they would be defective as a check on management itself. These limitations in the effectiveness of the internal control from the audit point of view may so reduce its value that the auditors will need to consider extending their audit procedures. This will require them to increase the amount of testing of transactions and to intensify the procedures for the verification of liabilities and assets including, for example, verification of stocktaking and confirmation of debtor balances by direct communication.

Where shortcomings in internal control arise because of small number of employees, the internal control letter, whilst acknowledging this should include suggestions for improvement. In such circumstances these would frequently take the form of suggestions for strengthening the director's supervision and control.

In the audits of small companies it will become necessary, despite an extension of detailed audit procedures to rely to a more significant extent on the representations of management, frequently not directly confirmed by outside evidence or by opening of or records maintained by other personnel of the company. In these circumstances, the auditors must consider whether their examination of records of the company, the evidence available to them and their knowledge of all the circumstances affecting the company are consistent with and support the representations of management for which direct confirmatory evidence is not available may not be relied on by the auditors. They must consider whether the surrounding evidence as a whole is consistent with and sufficient in their judgment to support these representations to their satisfaction.

If in the circumstances the auditors form the opinion that the records are adequate and have been properly maintained, they may place reliance on them as a basis for the preparation of accounts showing a true and fair view.

However, if they are not able to do this, it will be necessary for them to state clearly in the report the reservation they have to make.

(3) *Letter of representations* - After discussion with the directors at the conclusion of the audit and before signing the auditor's report, a letter of representation on the company's letter head addressed to the auditors should be obtained. The purpose of such letters is to place on record representation of management on significant matters affecting the account such as the ownership and basis of stating the amount of assets, liabilities, and

contingent liabilities. In addition, they act as a reminder to management of their responsibilities. Such letters, however, do not relieve the auditors of any of their responsibilities.

9.4.4 Audit of Charitable Institutions

In the case of the audit of a charitable institution, attention should be paid to the following matters :

(1) *General*

(a) Studying the constitution under which the charitable institution has been set up. It may be registered as a society under the Societies Registration Act, 1860 as a company limited by guarantee or as a trust. If the charitable institution is a public trust, the provision of the State Legislation, if any, affecting its accounts and audit should be taken into account.

(b) Verifying whether the institution is being managed in the manner contemplated by the law under which it has been set up.

(c) Examining the system of internal check, especially as regards accounting of amounts collected.

(d) Verifying in detail the income and confirming that the amounts received have been deposited in the bank regularly and promptly.

(2) *Subscriptions and donations*

(i) Ascertaining, if any, the changes made in amount of annual or life membership subscription during the year.

(ii) Whether official receipts are issued;

(a) confirming that adequate control is imposed over unused receipt books;

(b) obtaining all receipt books covering the period under review;

(c) test checking the counterfoils with the cash book; any cancelled receipts being specially looked into;

(d) obtaining the printed list of subscriptions and donations and agreeing them with the total collections shown in the accounts;

(e) examining the system of internal check regarding moneys received from box collections, flag days, etc. and checking the amount received from representatives, with the correspondence and the official receipts issued; paying special attention to the system of control exercised over collections and the steps taken to ensure that all collections made have been accounted for; and

(f) verifying the total subscriptions and donations received with any figures published in reports, etc. issued by the charity.

(3) *Legacies* - Verifying the amounts received by reference to correspondence with any figures and other available information.

(4) *Grants*

(a) Vouching the amount received with the relevant correspondence, receipts and minute books.

(b) Obtaining a certificate from a responsible official showing the amount of grants received.

(5) *Investments Income*

(a) Vouching the amounts received with the dividend and interest counterfoils.

(b) Checking the calculations of interest received on securities bearing fixed rates of interest.

(c) Checking that the appropriate dividend has been received where any investment has been sold ex. div. or purchased cum. div.

(d) Comparing the amounts of dividend received with schedule of investments making special enquiries into any investments held for which no dividend has been received.

(6) *Rents*

(a) Examining the rent roll and inspecting tenancy agreements, noting in each case :

(i) the amounts of the rents, and

(ii) the due dates.

(b) Vouching the rents on to the rent roll from the counterfoils of receipt books and checking the totals of the cash book.

(7) *Special function, etc.* - Vouching gross receipts and outgoings in respect of any special functions, *e.g.* concerts, dramatic performance, etc., held in aid of the charity with such vouchers and cash statements as are necessary. In particular, verifying that the proceeds of all tickets issued have been accounted for, after making the allowance for returns.

(8) *Income Tax Refunds* - Where income-tax has been deducted from the Investment income, it should be seen that a refund thereof has been obtained since charitable institutions are exempt from payment of Income-tax. This involves :

(a) vouching the Income-tax refund with the correspondence with the Income-tax Department; and

(b) checking the calculation of the repayment of claims.

(9) *Expenditure*

(a) Vouching payment of grants, also verifying that the grants have been paid only for a charitable purpose or purposes falling within the purview of the objects for which the charitable institution has been set up and that no trustee, director or member of the Managing Committee has benefited therefrom either directly or indirectly.

(b) Verifying the schedules of securities held, as well as inventories of properties both movable and immovable by inspecting the securities and title deeds of property and by physical verification of the movable properties on a test-basis.

(c) Verifying the cash and bank balances.

(d) Ascertaining that any funds contributed for a special purpose have been utilised for the purpose.

9.4.5 Audit of Educational Institutions : (School, College or University)

The special steps involved in their audit are the following :

(1) Examine the Trust Deed, or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulation framed thereunder.

(2) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.

(3) Check names entered in the Students Fee Register for each month or term, with the respective Class Registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.

(4) Check fees received by comparing counterfoils of receipts granted with entries in the Cash Book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

(5) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and that the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.

(6) Check admission fees with admission slips signed by the head of the institution and confirm that the amount has been credited to a Capital fund, unless the Managing Committee has taken a decision to the contrary.

(7) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the Rules prepared by the Managing Committee.

(8) Confirm that fines for late payment or absence, etc. have been either collected or remitted under proper authority.

(9) Confirm that hostel dues were recovered before students accounts were closed and their deposits of caution money refunded.

(10) Verify rental income from landed property with the rent rolls, etc.

(11) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.

(12) Verify any Government or local authority grant with the memo of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons thereof.

(13) Report any old heavy arrears on account of fees, dormitory rents, etc. to the Managing Committee.

(14) Confirm that caution money and other deposits paid by students on admission, have been shown as liability in the balance sheet not transferred to revenue, unless they are not refundable.

(15) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.

(16) Verify that the Provident Fund money of the staff has been invested in appropriate securities.

(17) Vouch donations, if any with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.

(18) Vouch, all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.

(19) Vouch, in the usual manner, all establishment expenses and enquire into any unduly heavy expenditure under any head. If there was any annual budget prepared, see that any excess under any head over the amount budget was duly sanctioned by the Managing Committee. If not, bring it to the Committee's notice in your report.

(20) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.

(21) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.

(22) Verify the inventories of furniture, stationery, clothing, provision and all equipment etc. These should be checked by reference to Stock Register or corresponding inventories of the previous year and values applied to various items should be test checked.

(23) Confirm that the refund of taxes deducted from the income from investment (interest on securities etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.

(24) Finally, verify the annual statements of account and, while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of staff, etc.

9.4.6 Audit of Hospital

The special steps involved in such an audit are stated below;

(1) Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

(2) Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills, etc.

(3) See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.

(4) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.

(5) Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).

(6) Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.

(7) Verify that grants, if any, received from Government or local authority have been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.

(8) Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.

(9) Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to insure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.

(10) See that depreciation has been written off against all the assets at the appropriate rates.

(11) inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

(12) Obtain inventories, specially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.

9.4.7 Audit of Club

A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 1956 relating to the audit of accounts of companies are also applicable to its audit. The special steps involved in such an audit are stated below :

(a) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes, of the Managing Committee.

(b) Vouch member's subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.

(c) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.

(d) Check totals of various columns of the Register of members and tally them across.

(e) See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.

(f) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.

(g) Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services, to members to confirm that the account of every member has been debited with amounts recoverable from him.

(h) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective stock registers.

(i) Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The stock of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.

(j) Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.

(k) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.

(l) Examine the financial powers of the secretary and, if these have been exceeded, report specific care for confirmation by the Managing Committee.

9.4.8 Audit of Cinema

The special steps involved in its audit are stated below :

(1) *Verify*

(a) that entrance to the cinema-hall during show is only through printed tickets;

(b) that they are serially numbered and bound into books;

(c) that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;

(d) that for advance booking a separate series of tickets is issued; and

(e) that the stock of tickets is kept in the custody of a responsible official.

(2) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

(3) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.

(4) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.

(5) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different show on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.

(6) Verify the charges collected for advertisement slides and shorts by reference to the Register of Slides and Shorts Exhibited kept at the cinema as well with the agreements, entered into with advertisers in this regard.

(7) Vouch the expenditure incurred on advertisement, repairs and maintenance. No part of such expenditure should be capitalised except the expenditure on extensive redecoration, and that should be adjusted as deferred revenue expenditure.

(8) Confirm that depreciation on machinery and furniture has been charged at an appropriate rate which are higher, as compared to those admissible in the case of other businesses, in respect of similar assets.

(9) Vouch payments on account of film hire with bills of distributors and in the process, the agreements concerned should be referred to.

(10) Examine unadjusted balance out of advance paid to the distributors against film hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquire as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.

(11) The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, cigarettes, etc. as in the case of club.

9.4.9 Audit of Hotels

There are many problems involved in any hotel audit, some of which are peculiar to the hotel industry such as control of cash assume greater proportions.

Almost all sales points in a hotel make both cash and credit sales. The auditor should reconcile the total sales reported with the total of the bills issued by the sales point; this total may take the form of a bill roll or a series of numerically controlled bills. This numerical control must be checked to ensure that all bills are included in the total. The cash element of the sales must then be checked to the cash records and the credit sales in total and detail to the guest's bills.

The special problems in a hotel audit can be summarised as follows :

(1) *Internal Controls* - Pilfering is one of the greatest problems in any hotel and the importance of internal control cannot be over stressed. It is the responsibility of management to introduce controls which will minimise the leakage as far as possible. Evidence of their success is provided by the preparation of regular perhaps weekly, trading accounts for each sales point and a detailed scrutiny of the resulting profit

percentages, with any deviation from the anticipated form being investigated. The auditor should obtain these regular trading accounts for the period under review, examine them and obtain explanations for any apparent deviations.

If the internal control in a hotel is weak or perhaps breaks down, then a very serious problem exists for the auditor. As a result of the transient nature of many of his clients' records, the auditor must rely to a very large extent on the gross margin shown by the accounts. As a result, the scope of his audit tests will necessarily be increased and, in the event of a material margin discrepancy being unexplained he will have to consider qualifying his audit report.

(2) *Room Sales* - The charge for room sales is normally posted to guest bills by the receptionist or in the case of large hotels by the night auditor. The source of these entries is invariably the guest register and audit tests should be carried out to ensure that the correct number of guests are charged for the correct period. Any difference between the charge rates used on the guests' bills and the standard room rate should be investigated to ensure that they have been properly authorised.

In many hotels, the housekeeper prepares a daily report of the rooms which were occupied the previous night and the number of beds kept in each room. This report tends not to be permanently retained and the auditor should ensure that a sufficient number of reports are available for him to test both with the guest register and with the individual guest's bill.

(3) *Stocks* - The stocks in any hotel are both readily portable and saleable particularly the food and beverage stocks. It is therefore extremely important that all movements and transfers of such stocks should be properly documented to enable control to be exercised over each individual stores areas and sales point. The auditor should carry out tests to ensure that all such documentation is accurately processed.

Areas where large quantities of stock are held should be kept locked, the key being retained by the departmental manager. The key should be released only to trusted personnel and unauthorised persons should not be permitted in the stores areas except under constant supervision. In particular, any movement of goods in or out of the stores should be checked, it is not unknown for a full crate to be removed in error as an empty crate.

Many hotels use specialised professional valuers to take and value the stocks on a continuous basis throughout the year. Such a valuation is then almost invariably used as the basis of the balance sheet stock figure at the year end. Although such valuers are independent of the audit client, it is important that the auditor satisfies himself that the amounts included for such stocks are reasonable. In order to satisfy himself of this the auditor should consider attending at the physical stock taking and carrying out certain

pricing and calculation tests. The extent of such tests could well be limited since the figures will have been prepared independently of the hotel.

(4) *Fixed Assets* - The accounting policies for fixed assets of individual hotels are likely to differ. However, many hotels account for certain quasi-fixed assets such as silver and cutlery on stock basis. This can lead to confusion between each stock items and similar assets which are accounted for on a more normal fixed assets basis. In such cases it is important that very detailed definitions of stock items exist and the auditor should carry out tests to ensure that the definitions have been closely followed.

(5) *Casual Labour* - The hotel trade operates to very large extent of casual labour. The records maintained of such wage payments are frequently inadequate. The auditor should ensure that defalcation on this account does not take place by suggesting proper controls to the management.

(6) *Other points :*

(i) For ledgers coming through travel agents or other booking agencies the bills are usually made on the travel agents or booking agencies. The auditor should that money are recovered from the travel agents or booking agencies as per the terms of credit allowed.

(ii) Commission, if any, paid to travel agents or booking agents should be checked by reference to the agreement on that behalf.

(iii) The auditor should ensure that proper records re-maintained for booking of halls and other premises for special parties and recovered on the basis of the tariff.

(iv) The auditor should verify a few restaurant bills by reference to K.O.T.s (Kitchen Order Tickets) or basic record. This would enable the auditor to ensure that controls regarding revenue cycle are in order.

(v) The auditor should see that costs of renovation and redecoration are treated as deferred revenue expenditure, where as costs of major alterations and additions to the hotel building and facilities capitalised.

(vi) The auditor should ensure that proper valuation of occupancy-in-progress at the balance sheet date is made and included in the accounts.

(vii) The auditor should satisfy himself that all taxes collected from occupants on food and occupation have been paid over to the proper authorities.

(viii) In large hotels it is usual to operate a booth to facilitate conversion of foreign currencies to Indian rupees. The auditor should ensure compliance with the various applicable provisions of Foreign Exchange Regulation Act, 1973 and the rules framed by Foreign Exchange Dealer's Association.

9.4.10 Audit of Hire Purchase and Leasing Companies

Generally speaking, hire-purchase agreement means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which:

(i) possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments, and

(ii) the property in the goods is to pass to such person on the payment of the last of such instalments, and

(iii) such person has a right to terminate the agreement at any time before the property so passes.

Thus hirer means the person who obtains or has obtained possession of goods from an owner under a hire- purchase agreement and owner means the person who lets or has let, delivers or has delivered possession of goods to a hirer under a hire-purchase agreement in order to complete the purchase of, or the acquisition of property in the goods of which the agreement relates; and includes any sum so payable by the hirer under the hire-purchase agreement by way of a deposit or other initial payment. While checking the hire-purchase transaction, the auditor may examine the following :

1. Hire purchase agreement is in writing and is signed by all parties.
2. Hire purchase agreement specifies clearly :
   (a) The hire-purchase price of the goods to which the agreement relates;
   (b) The cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
   (c) The date on which the agreement shall be deemed to have commenced;
   (d) The number of instalments by which the hire- purchase price is to be paid, the amount of each of those instalments, and the date, or the mode of determining the date, upon which it is payable, and the person to whom and the place where it is payable; and
   (e) The goods to which the agreement relates, in a manner sufficient to identify them.
3. Ensure that payments are being received regularly as per the agreement.

In a lease agreement, a party (called 'lessee') acquires the right to use an asset for an agreed period of time in consideration of payment of rent to another party (called 'lessor'). In certain lease agreements, the legal ownership of the asset remains with the lessor (the leasing company), but in substance, all the risks and rewards of ownership of the asset are transferred to the lessee. In other words, the lease is, in effect, a financing

arrangement. Such leases are termed as finance leases. An operating lease, on the other hand, is a simple arrangement where, in return for rent, the lessor allows the lessee to use the asset for a certain period.

A normal financial lease transaction usually goes through the following modality:

The lessee will select the equipment, and satisfy himself about its functional fitness and specifications, the lessor has no participation at this stage.

Having chosen the equipment, the lessee approaches a lessor, either directly or through a lease-broking agency.

The lease agreement is broadly negotiated and the rates are finalised.

The lessor places an order on the manufacturer as chosen by the lessee.

The manufacturer delivers the equipment at the site of the lessee, and the latter gives notice of acceptance to the lessor.

The lease agreement giving detailed terms of contract is signed between the parties. Leases will normally be full pay-out, with term varying as per requirements.

During the lease period, the lessee :

- Will pay rentals regularly at periods agreed-upon, which are usually each calendar month;
- Will keep the equipment in good repair and working condition, etc.
- Will be entitled to any manufacturer's warranties or after-sales services.

At the end of the lease period, the equipment shall retreat to the lessor. The lessee may, however, be given a renewal right, or may be allowed to participate in purchase of the equipment when the lessor intends to sell it. No purchase option shall be given to the lessee in the lease agreement itself.

In respect of leasing transaction entered into by the leasing company, the following procedures may be adopted by the auditor.

1. the object clause of leasing company to see that the goods like capital goods, consumer durables etc. in respect of which the company can undertake such activities. Further, whether company can undertake financing activities or not.
2. Whether there exists a procedure to ascertain the credit analysis of lessee like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security, etc.
3. The lease agreement should be examined and the following points may be noted:

(i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or makings to be attached to the equipment).

(ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.

(iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.

(iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

4. Examine the lease proposal form submitted by the lessee requesting the lessor to provide him the equipment on lease.

5. Ensure that the invoice is retained safely as the lease is a long-term contract.

6. Examine the acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.

7. See the Board resolution authorising a particular director to execute the lease agreement has been passed by the lessee.

8. See that the copies of the insurance policies have been obtained by the lessor for his records.

Self-examination Questions

1. From the list given below state the items which cannot be considered as direct benefits derived from a professional audit :

(i) Reduction in tax liability.

(ii) Settlement of partner's accounts.

(iii) Safety of the investments.

(iv) Safeguarding of the assets.

(v) Acquaintance with current professional thinking in the matter of accounting principles and its application.

(vi) Increased creditworthiness.

(vii) Stocks cannot be pilfered.

(viii) Workers get pay in time.

(ix) Check workers' absence.

(x) Proper books of account are maintained.

(xi) Staff keeps the work upto date.

(xii) Internal control is strengthened.

(xiii) The auditor is always available for advice.

(xiv) Ascertainment of correct profit/loss is ensured.

(xv) Frauds can be unearthed.

(xvi) No mistake can remain in the accounts.

(xvii) Directors cannot spend company's money on personal benefit.

(xviii) Prudence or imprudence of entering into any transactions is revealed.

(xix) Make maintenance of costing records compulsory.

(xx) Expenses are authorised by the auditor.

2. State which of the undermentioned statements are incorrect :

(i) There is a statutory form of audit report for registered firms.

(ii) For the audit of cinema houses, it is necessary to actually see the films.

(iii) Distributors' representatives certify the sale-proceeds from the exhibition of films.

(iv) It is preferable to indicate in the audit report on the account of a sole trader whether the auditor has been able to obtain all the necessary information and explanation.

(v) An auditor is responsible to none except his client in case the client is a sole proprietor.

(vi) Even under the Indian Partnership Act, there are enough advantages if the accounts are audited.

(vii) Capital and profit-sharing agreement are both essential to constitute a Partnership.

(viii) Partners are entitled to interest on loan under the act unless otherwise agreed.

(ix) Unregistered partnerships need not keep any books of account.

(x) The matters to be kept in view in the audits of partnerships and sole proprietary business are generally similar.

(xi) Auditors always prepare tax returns.

(xii) A charitable institution may be a company.

(xiii) Companies cannot give money for charity.

(xiv) Operation of the bank account of a firm is subject of the auditor's supervision.

(xv) Hospitals keep an account for physicians' skills.

3. Of the following some points are irrelevant in respect of audit of charitable institutions such as schools and hospitals. State which and arrange the others in the order of importance.

(a) Nature of Constitution

(b) Avenues of raising funds

(c) Management

(d) Payment of Bonus

(e) Government Policy in respect of social welfare

(f) Heads of expenditure

(g) Taxation

(h) List of patrons

(i) Objectives

(j) Nature of records to be kept

(k) Means available to realise objective

(l) Staff composition

(m) In-built power to sustain and exist

(n) Volume of income

(o) Public image

4. Mention any eight special points which you, as an auditor, would look into while auditing the books of:

(a) Hotel

(b) Club

(c) A Library

(d) Charitable Institution

(e) A Cinema

(f) A Hospital

5. You have been asked to audit the accounts of a Publishing Company. Draw up a suitable audit programme for the said audit, and also disclose in brief the points which you would consider while drawing up the said audit programme.

6. What special points you will take into consideration in auditing the accounts of Hotels?

7. Mention the points to be considered in the audit of a leasing company involved in the leasing of capital goods.

8. (a) Discuss the problems which are encountered while shifting from manual-based accounting records to computer-based accounting records.

   (b) What do you understand by 'Audit through the Computer'?

9. (a) You have been appointed auditor for the first time of a small partnership firm carrying on business for last several years. What special information you would obtain before commencing the audit?

   (b) What would be your duties and responsibilities towards its audit problems and how would you overcome them?

10. (a) What do you understand by the term 'Government Auditing'?

    (b) Discuss the duties of C & AG within the framework of the Constitution of India.

11. (a) What are the important features of distinction between computer - based system of accounting and those of a conventional nature?

    (b) What are the administrative controls which ensure an acceptable standard of discipline and efficiency in a computer based accounting system?

12. What are special steps involved in conducting the audit of a college?

13. Mention the important items to be examined by the auditor in the audit of a Hospital.

14. Mention six basic item with which the auditor should be familiar to understand the computer system used by the client.

15. Mention the important matters requiring the attention of the auditor in the audit of a charitable institution.

16. (a) What are the types of internal control in a computer-based system ?

    (b) Briefly explain the important aspects in system development controls.

17. In respect of Government Audit, explain:

    (a) Propriety Audit

    (b) Audit of Stores and Stocks

    (c) Powers of the Comptroller and Auditor General under section 619(3) & (4) of the Companies Act, 1956.

18. Mention the important items to be examined by the auditor in the audit of a Hospital.

19. Distinguish between:

    (i) Auditing around the computer; and

    (ii) Auditing with the computer.

20. (a) (i) In carrying out an audit against provision of funds, what aspects would you consider?

    (ii) As an auditor, how will you react to an expenditure incurred by a government department which was sanctioned by a fellow officer of the competent authority as the concerned officer was on leave.

    (iii) The Assessing Officer in order to ensure that there was no loss of revenue, increased the income of all assessees between 50% to 100%.

    State your views, if you were entrusted to carry out an audit of receipts of the said assessing department.

    (b) State the special points you as an auditor will consider while conducting the audit of a cinema.

Multiple Choice Questions

1. The scope of the audit including reference to the pronouncements of the ICAI, which the auditor adheres to, generally is communicated to the client in the —

    (i) auditor's report

    (ii) Engagement letter

(iii) Representation letter

(a) (i) Only

(b) Both (i) and (ii)

(c) Both (i) and (iii)

(d) All of the above.

2. If any director is disqualified from being appointed under section 274(1)(g), the auditor should mention this fact in his audit report. For this purpose, how does he determine their eligibility —

(a) He obtains a representation form each director.

(b) He obtains a management representation.

(c) He enquiries from Registrar of Companies.

(d) Any one of the above.

3. As per the 'Statement on Qualifications in Auditor's Report' issued by the ICAI, the auditor, under section 227(3) has to give a statement of fact on —

(a) Proper books of account.

(b) Accounting standards.

(c) Cess payable under section 441A.

(d) None of the above.

4. As per AAS-228,which of the following is not mentioned in the scope paragraph of auditor's report.

(a) He gives reasonable assurance.

(b) He adopts sampling procedure to obtain evidence.

(c) He assesses the reasonableness of management's estimates.

(d) The assesses the reasonableness of management's estimates.

5. As per AAS-228, the place mentioned in the Auditor's report is —

(a) The city of the registered office of the client

(b) The city at which the office of the auditor is maintained

(c) The city at which books of account are kept

(d) The city where the auditor drafted the audit report.

6. The date on auditor's report should not be —

(a) The date of AGM.

(b) Later than the date on which the accounts are approved in board's meeting

(c) Earlier than the date on which the accounts are approved by the management

(d) Both (a) and (b)

7. Section 227(2) of the Companies Act,1956 requires the auditor to give his report to the members of the company on certain matters. Which of the following is not included in the above ?

(a) Accounts examined by him.

(b) Every balance sheet and profit and loss account laid before a general meeting during his tenure;

(c) Every document that is a 'part of' or 'annexed to' the balance sheet.

(d) Every document which is attached to the profit and loss account.

8. When restrictions that significantly affect the scope of the audit are imposed by the client, the auditor generally should issue which of the following opinions ?

(a) Qualified opinion.

(b) Disclaimer of opinion.

(c) Adverse opinion.

(d) Unqualified report with 'an emphasis of matter' paragraph'.

9. Which of the following will not result in qualification of the auditor's opinion due to a scope limitation ?

(a) Restrictions the client imposed

(b) Reliance on the report of other auditor

(c) Inability to obtain sufficient appropriate evidential matter.

(d) Inadequacy of accounting records.

10. The inventory consists of about one per cent of all assets. The client has imposed restriction on auditor to prohibit observation of stock take. The auditor cannot apply alternate audit procedures. The auditor should issue :

    (a) Unqualified opinion

    (b) Qualified opinion

    (c) Disclaimer of opinion

    (d) Adverse opinion.

11. If in the above question, the inventory consisted of about ten per cent of total assets, other conditions remaining same, the auditor should issue --

    (a) Unqualified opinion

    (b) Qualified opinion

    (c) Disclaimer of opinion

    (d) Adverse opinion.

12. The auditor has serious concern about the going concern of the company. It is dependent on company's obtaining a working capital loan form a bank which has been applied for. The management of the company has made full disclosure of these facts in the notes to the balance sheet. The auditor is satisfied with the level of disclosure. He should issue —

    (a) Unqualified opinion

    (b) Unqualified opinion with reference to notes to the accounts

    (c) Qualified opinion

    (d) Disclaimer of opinion

13. Which of the following is true about explanatory notes ?

    (a) These are given by the directors of the company.

    (b) These are given to adhere to requirements of section 211.

    (c) Theses are given by auditors of the company in auditor's report.

    (d) All of the above.

14. The client changed method of depreciation from straight line to written down value method. This has been disclosed as a note to the financial statements. It has an immaterial effect on the current financial statements. It is expected, however, that the change will have a significant effect on future periods. Which of the following option should the auditor express ?

    (a) Unqualified opinion

    (b) Qualified opinion

    (c) Disclaimer of opinion

    (d) Adverse opinion.

15. Which of the following is not true regarding requirements under section 227(3)(f) of the Companies Act,1956 ?

    (a) The auditor has to satisfy himself whether any of the directors of the company, whether public or private, are disqualified from being appointed as a director as per section 274 (1)(g).

    (b) Section 274(1)(g) is applicable to appointment of directors both in public and private companies but reporting is limited to only those directors of a company who are also directors of a public company.

    (c) The auditor requires every director to submit a written representation in respect of each public company, of which he is a director, as to whether such company has defaulted in terms of provisions of section 274(1)(g).

    (d) The disqualification should be considered on the date of audit report.

16. The management of a company, to which AS-3, is not applicable, does not include statement of cash flows in its annual report. The auditor should express —

    (a) Unqualified opinion

    (b) Qualified opinion

    (c) Adverse opinion.

    (d) Any of these depending upon materiality and pervasiveness and adequacy of disclosure.

17. In case the auditor gives a disclaimer of opinion in the audit report which of the following paragraph (s) of a standard unqualified audit report are modified ?

    (a) Scope paragraph

    (b) Opinion Paragraph

    (c) Scope and opinion

    (d) Introductory, scope and opinion paragraph.

18. A Departure form recognised accounting principles is disclosed in a note to the financial statements. The auditor should

    (a) Issue a standard unqualified audit report

    (b) Issue a qualified report

    (c) Issue an unqualified report with 'emphasis of matter' paragraph

    (d) Disclaim opinion.

19. AB& Co., chartered accountants, have been requested by their client XYZ Ltd. Not to confirm accounts receivable because of concerns about creating conflicts with customers over amounts owed.The auditors were satisfied concerning receivables after applying alternative audit procedures. AB & Co.'s auditor's report likely contained a(n).

    (a) Qualified opinion

    (b) Disclaimer of opinion

    (c) Unqualified opinion with an explanatory paragraph

    (d) Unqualified opinion

20. The auditor should state the reasons for his reservations in audit report and should try to quantify the effect on them. This should be done in case he has expressed —

    (i) A qualified opinion

    (ii) An unqualified opinion with emphasis of matter paragraph

    (iii) An adverse opinion

    (iv) A disclaimer of opinion

    (a) (i) Only

    (b) (i) and (iv) (i),

(c) (iii) and (iv) only

(d) All of the above.

21. Companies exempted from application of CARO, 2003 does not include –

(a) A banking company

(b) An insurance company

(c) A private limited company with paid up capital and reserves not more than fifty five lakh rupees.

(d) A licensed company.

22. Under CARO, 2003, the auditor's report should include report about maintenance of proper records relating to --

(a) Fixed assets and cost

(b) Fixed assets, cost and investments

(c) Fixed assets, cost, investments and inventories

(d) Fixed assets, cost and inventory.

23. Under CARO, 2003 the auditor is required to report on --

(a) Arrears of cumulative preference dividends

(b) Preferential allotment of shares to related-party

(c) Disposal of fixed assets and its effect on going concern.

(d) Unsecured loans granted to related party.

24. As per CAG's (DPC) Act, 1971 the tenure of the Comptroller and Auditor General is ……years.

(a) Four

(b) Five

(c) Six

(d) Seven

25. The part of Government Audit which is concerned with examining whether the money has been spent for the purpose specified in Appropriation Act is called —

(a) Audit of Sanctions

(b) Audit of provision of funds

(c) Audit of rules and orders

(d) Audit of financial property

26. Audit of transaction does not include —

(a) Propriety audit

(b) Efficiency-cum-performance audit

(c) Audit of receipts

(d) Audit of expenditure

26. The Income Tax Department has sent Mr. X double refund of advance tax. The Government Auditor detected this while conducting —

(a) Audit of expenditure

(b) Performance audit

(c) Audit of stores and stock

(d) Audit of receipts

27. 5. Audit of debt, deposits and remittances does not cover —

(a) Audit of borrowings

(b) Audit of amortisation of debt

(c) Audit of sanctions

(d) Remittance audit

28. A Sate Government spent rupees fifty lakes on renovation of 'Raj Bhavan' for its Governor.In the CAG's opinion, this expenditure was more than what occasion demanded ? It is an example of —

(a) Propriety audit

(b) Performance audit

(c) Audit against provision of funds

(d) None of the above

29. Audit reports on PSUs are —

(a) Submitted to the president/Governor for being laid before the Parliament.

(b) Sent to concerned ministries/departments

(c) Submitted to BODs of concerned PSU.

(d) Any of the above.

30. The CAG, some years ago, gave adverse comments on expenditure incurred on buying coffins for soldiers killed in a war. In his opinion, the coffins cases imported could have been replaced with less expensive, domestically produced ones. This is an aspect of

(a) Audit of sanctions

(b) Audit of stores and stocks

(c) Propriety audit

(d) Both (b) and (c)

31. Who among the following is eligible to be appointed as an audit of a government company ?

(a) A Chartered Accountant in practice

(b) A Chartered Accountant whether in practice or not

(c) An auditor appointed by the CAG

(d) Any of the above.

32. The statutory auditor of a Government Company submits his report to —

(a) The BoDs of the company

(b) The CAG

(c) The Legislature

(d) The company secretary.

APPENDIX I

ANSWERS TO THE MULTIPLE CHOICE QUESTIONS

- **CHAPTER 1**

Answers :

1. (d), **2.** (a), **3.** (a), **4.** (b), **5.** (a), **6.** (d), **7.** (b), **8.** (c), **9.** (b), **10.** (a) **11.** (b), **12.** (d), **13.** (a), **14.** (c), **15.** (b), **16.** (d), **17.** (b), **18.** (a), **19.** (d), **20.** (b), **21.** (a), **22.** (a), **23.** (b), **24.** (b), **25.** (d), **26.** (c), **27.** (c), **28.** (d), **29.** (d), **30.** (c), **31.** (c), **32.** (d), **33.** (d), **34.** (b), **35.** (d), **36.** (b), **37.** (c), **38.** (d), **39.** (c).

- **CHAPTER 2**

Answers :

1. (c), **2.** (b), **3.** (d), **4.** (c), **5.** (a), **6.** (b), **7.** (d), **8.** (b), **9.** (d), **10.** (d) **11.** (d), **12.** (b), **13.** (b), **14.** (c), **15.** (a), **16.** (d), **17.** (a), **18.** (a), **19.** (b), **20.** (d), **21.** (a), **22.** (d), **23.** (c), **24.** (c), **25.** (c), **26.** (a), **27.** (d), **28.** (a), **29.** (b), **30.** (a), **31.** (c).

- **CHAPTER 3**

Answers :

1. (c), **2.** (d), **3.** (c), **4.** (a), **5.** (d), **6.** (c), **7.** (a), **8.** (a), **9.** (c), **10.** (c).

- **CHAPTER 4**

Answers :

1. (a), **2.** (c), **3.** (d), **4.** (c), **5.** (c), **6.** (b), **7.** (c), **8.** (c), **9.** (b), **10.** (a) **11.** (d), **12.** (d), **13.** (b), **14.** (a), **15.** (d), **16.** (b).

- **CHAPTER 5**

Answers :

1. (c), **2.** (a), **3.** (c), **4.** (d), **5.** (c), **6.** (c), **7.** (a), **8.** (d), **9.** (a),
10. (b) **11.** (a), **12.** (d), **13.** (d), **14.** (a), **15.** (c), **16.** (c), **17.** (b), **18.** (d),
19. (d), **20.** (d).

- **CHAPTER 6**

Answers :

1. (c), **2.** (b), **3.** (d), **4.** (a), **5.** (b), **6.** (c), **7.** (a), **8.** (c), **9.** (c),
10. (c), **11.** (a), **12.** (c), **13.** (d), **14.** (b), **15.** (c), **16.** (d), **17.** (a), **18.** (d),
19. (d), **20.** (a), **21.** (b), **22.** (c), **23.** (d), **24.** (c), **25.** (d), **26.** (a), **27.** (c),
28. (a), **29.** (c), **30.** (b), **31.** (d), **32.** (d), **33.** (a), **34.** (b), **35.** (b), **36.** (a),
37. (c).

- **CHAPTER 7**

Answers :

1. (b), **2.** (a), **3.** (c), **4.** (d), **5.** (d), **6.** (b), **7.** (a), **8.** (b), **9.** (a),
10. (b), **11.** (c), **12.** (c), **13.** (d), **14.** (a), **15.** (b), **16.** (c), **17.** (a), **18.** (c),
19. (d), **20.** (d), **21.** (b), **22.** (c), **23.** (d), **24.** (b), **25.** (d), **26.** (b), **27.** (b)
28. (b), **29.** (c), **30.** (b), **31.** (d), **32.** (c), **33.** (b), **34.** (a), **35.** (d), **36.** (b).

- **CHAPTER 8**

Answers :

1. (d), **2.** (b), **3.** (c), **4.** (b), **5.** (d), **6.** (d), **7.** (a), **8.** (c), **9.** (b),
10. (d), **11.** (d), **12.** (a).

- **CHAPTER 9**

Answers :

1. (b), **2.** (a), **3.** (c), **4.** (d), **5.** (b), **6.** (c), **7.** (d), **8.** (a), **9.** (b),
10. (a), **11.** (c), **12.** (b), **13.** (a), **14.** (a), **15.** (d), **16.** (a), **17.** (c), **18.** (b),
19. (c), **20.** (d), **21.** (c), **22.** (c), **23.** (a), **24.** (c), **25.** (b), **26.** (b), **27.** (c),
28. (a), **29.** (b), **30.** (d), **31.** (a), **32.** (b).

APPENDIX II

A SUMMARY OF THE SIGNIFICANT LEGAL DECISIONS

THE LEEDS ESTATE BUILDING AND INVESTMENT COMPANY V. SHEPHERD (1887)

This case was decided by Mr. Justice Stirling in the Chancery Division on 9th August, 1887.

Held, that it was an auditor's duty to ascertain that the accounts he certifies are correct and that if he fails in this duty he is liable in damages for dividends wrongly paid out of capital.

The company was formed in 1869 under the Companies Act, 1862. In 1882 it went into voluntary liquidation and the action was brought by the company in liquidation against the directors, the manager, and the auditor, to make them liable in respect of certain sums paid out of capital as dividends, and for fees and bonuses to the directors and manager respectively.

The balance sheets, which were not shown to the shareholders as required by the articles, were found to be false and to have been prepared to enable the declaration of a dividend. They were prepared by the manager and examined by the auditor. The directors trusted these two officials and did not know that the accounts were inaccurate and that dividends were paid out of capital.

The Court found the directors liable to make good the several sums paid out of capital and that the manager and auditor were liable to the same amount; that the auditor must not confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but must see that it was a true representation of the company's affairs; that it was no excuse that the auditor had not seen the articles; that the Statute of Limitations enabled the auditor's liability to be limited to dividends paid within six years of the commencement of the action.

LEE v. NEUCHATEL ASPHALTE COMPANY LIMITED (1889)

This case was decided in the Court of Appeal on the 9th of February, 1889, when it was held that a company, if allowed by its articles of association, may provide for the distribution of profits arrived at before making good the depreciation of fixed assets.

Briefly, the facts of the case were these : The action was brought by a Mr. Lee, on behalf of himself and all the ordinary shareholders of the Neuchatel Asphalte Co. Ltd., against the company and the directors. The object of the action was to restrain the payment of a dividend proposed to be declared, because, as the plaintiff contended, proper provision had not been made for depreciation in respect of the wasting nature of the property. The assets of the company consisted chiefly of a concession to work at quarry, and other subsidiary rights taken over from previously existing companies, for which fully-paid shares in the respondent company had been allotted in payment. The accounts for the year ended 31st December, 1885, showed an excess of receipts over expenditure to the amount of £17,140 13s. 2d., out of which, after setting aside a sum of £1,000, in partial recoupment of a sum of £8,000 paid in 1878 for the renewal of the concession, it was recommended by the directors, and resolved by a majority of the shareholders, that a dividend on the preferred shares at the rate of 9s. per share should be paid.

The Court dismissed the appeal, refusing to grant an injunction to restrain the proposed dividend being paid.

Lord Justice Cotton, in the course of his judgment, said that in his opinion

> 'it was not necessary that the directors should set apart each year a sum to answer the supposed annual diminution of this property by reason of its wasting nature',

and that

> 'having regard to the nature and constitution of this mercantile company, he was not satisfied that a proper provision had not been made for depreciation by the establishment of a reserve fund, and considered that it would be wrong for the Court to interfere to prevent the payment of the proposed dividend'.

Lord Justice Lindley, in the course of his judgment, said :

> 'It has been very judiciously and properly left to the commercial world to settle how the accounts are to be kept. The Acts do not say what expenses are to be charged to Capital Account and what to Revenue Account. Such matters were left to the shareholders; they may or may not have a sinking fund or depreciation fund, the articles may or may not contain regulations on these matters; if they do, the regulations must be observed; if they do not, the shareholders can do as they like, so long as they do not misapply their capital. In this case one of the articles provides that the directors shall not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession.... But if a company is formed to acquire or work property of a wasting nature—e.g., a mine, quarry, or patent—the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the property over the cost of

working it may be divided among the shareholders; and this is true, although some portion of the property itself is sold, and in one sense the capital is thereby diminished. If it be said that such a course involves payment of dividends out of capital, the answer is that the Acts nowhere prohibit such a payment as is here supposed.... In the present case the articles say there need be no sinking fund; consequently, capital lost need not be replaced; nor, having regard to these articles, need any loss of capital by removal of bituminous earth appear in the Profit and Loss Account of the working of the company's property.'

Lord Justice Lopes, in his judgment, referred to the article providing that the directors should not be bound to reserve moneys for the renewal or replacing of any lease or of the company's interest in any property or concession and proceeded :

'Unless this article is ultra vires no question arises. Is the article ultra vires? I know of no obligation imposed by law or statute to create a reserve fund out of revenue to recoup the wasting nature of capital. Subject to any provision to the contrary contained in the articles, I believe the disposition of the revenue is entirely in the hands and under the control of the company.'

BOLTON v. THE NATAL LAND AND COLONISATION COMPANY LIMITED (1891)

(92 L.T. Rep. 109)

This case was decided before Mr. Justice Romer in the Chancery Division on the 8th, 9th and 10th of December, 1891.

In 1882 the company in question, under peculiar circumstances, debited their Profit and Loss Account with £70,000 in writing off a certain bad debt, and per contra, credited the same Profit and Loss Account with a sum of nearly £70,000 in respect of an increase in value attributed to their lands in South Africa above and beyond the cost price at which such lands previously stood in the books, the result being to make the profit and loss practically balance each other upon the year's accounts. The company having subsequently earned a working profit, declared a dividend thereout, in respect of the year 1885. Thereupon the plaintiff, in an action commenced in 1886 to restrain the payment of such dividend, contended that at the time the value of the lands was written up in 1882 they were valued, and now stood, at an amount considerably exceeding their true value, and that, before a profit could be deemed to have been made which would be properly available for the payment of a dividend, the lands in question must be written down to their true value, and the difference debited to Profit and Loss Account in the same way as the supposed increase had been credited to Profit and Loss Account for the year 1882.

It was held by Mr. Justice Romer that, assuming that a part of the capital had in fact been lost, and not subsequently made good, no sufficient ground was thereby afforded for restraining the payment of the dividend; that the fact of the company having written up the value of their land in 1882, and credited the increase to the profit of that year in the manner described, did not place them under any obligation to bring into account in every subsequent year the increase or decrease in the value of their lands; and that, having regard to the case of Lee v. Neuchatel Asphalte Co. Ltd., it was not correct, in estimating the profits of a year, to take into account the increase or decrease in the value of the capital assets of the company.

LUBBOCK v. THE BRITISH BANK OF SOUTH AMERICA LIMITED (1892)

This case was decided before Mr. Justice Chitty, in the Chancery Division, on 1st April, 1892, when it was held that, if a company's articles of association so provide, a profit made on the sale of a part of the undertaking is available for dividend.

The case was a motion by the plaintiff on behalf of himself and all the other shareholders of the defendant company to restrain the company from acting upon or carrying into effect a resolution passed by the directors of the company placing a sum of £205,000 to the credit of the Profit and Loss Account, and from dealing with or distributing the same as if it were the income of the company. The £20,000 in question was a realised profit made by the company on the sale of a part of its undertaking to another concern. The action was a friendly one, both parties being desirous of obtaining the opinion of the Court.

It was held by Mr. Justice Chitty that the £205,000 was plainly profit on capital, and not part of the capital itself, for that sum was the surplus ascertained on the assets aside after the liabilities and capital were placed on one side of the account and the assets on the other. Under the articles of the company the directors were justified in carrying over the £205,000 to a Profit and Loss Account, and having appropriated to the reserve fund so much of the sum as they thought fit they could distribute the remainder as dividends after an ordinary meeting called in pursuance of the articles had passed the requisite resolution.

VERNER V. THE GENERAL AND COMMERCIAL INVESTMENT TRUST LIMITED (1894)

This case was decided in the Court of Appeal on the 7th April, 1894. The decision was to the effect that an injunction to restrain a company from paying a proposed dividend out of current profits, on the ground that the capital of the company is not intact, must be refused if the company is solvent and is acting within its articles.

The facts were these : Mr. William Henry Verner, on behalf of himself and all other stockholders of the defendant company, other than the directors, sought an injunction restraining the defendants from declaring and distributing any dividend in respect of the financial year terminating on 28th February, 1894. The company's share capital amounted to

£600,000, all of which had been received in cash. It had also received £300,000 as a result of an issue of debenture stock to that amount. There had thus come to the hands of the company £900,000, which had been invested in various securities authorised by the memorandum of association. The present market value of such investments was only £654,776, showing a depreciation of over £240,000, of which it was contended £75,000 was hopelessly lost. Apart from this there was an excess of income over expenditure amounting to £23,000. The question for the Court was whether, there being a loss of capital to the amount of £75,000, and an excess of income over expenditure of £23,000, a dividend could lawfully be declared and paid.

Lord Justice Lindley delivered the judgment of himself and Lord Justice A.L. Smith. He said :

> 'The broad question raised by this appeal is whether a limited company which has lost part of its capital can lawfully declare or pay a dividend without first making good the capital which has been lost. I have no doubt it can—that is to say, there is no law which prevents it in all cases and under all circumstances. Such a proceeding may sometimes be very imprudent, but a proceeding may be perfectly legal and may yet be opposed to sound commercial principles. We, however, have only to deal with the legality or illegality of what is complained of.... It is plain that there is nothing in the memorandum and articles which requires lost capital to be made good before dividends can be declared. On the contrary, they are so framed as to authorise the sinking of capital in the purchase of speculative stocks, funds and securities, and the payment of dividends out of whatever interests, dividends, or other income such stocks, funds, and securities yield, although some of them are hopelessly bad, and the capital sunk in obtaining them is lost beyond recovery. There is no suggestion of any improper juggling with the accounts, and there is no payment of dividend out of capital. There is no insolvency, and we have not to deal with a petition to wind up. Some capital is lost, but that is all that can be truly said, and that is not enough to justify such an injunction as is sought. The appeal is dismissed.'

WILMER v. M'NAMARA & COMPANY LIMITED (1895)

This case was decided before Mr. Justice Stirling, in the Chancery Division, on the 26th April, 1895.

This was a motion on behalf of the ordinary shareholders of the defendant company asking for an injunction to restrain the directors from acting upon a resolution passed at a general meeting of the company that a sum of £5,816 12s. 6d. should be applied in payment of a dividend to the preference shareholders, and also from declaring and paying any dividend for the year ending 30th June, 1894. The real object of the action, which was a friendly one, was to ascertain whether or not the dividend in question could be lawfully paid, in view of the fact that a valuation made of the company's assets showed a figure very much below the amount at which the assets stood in the books. The company's business was that of general carriers

of mails, parcels, goods, & c., and the assets consisted of goodwill, leasehold premises, horses, vans, plant, &c.

Mr. Justice Stirling, in the course of his judgment, said :

'It is necessary to consider whether the depreciation in goodwill and leaseholds is to be treated as loss of "fixed" capital or of "floating" of "circulating" capital, and on this point I am of opinion that it is to be treated as loss of "fixed" capital... I think that the Balance Sheet cannot be impeached simply because it does not charge anything against revenue in respect of good-will. I feel much more doubt whether £200 is a sufficient sum to allow in respect of depreciation of leaseholds, but I do not think under the circumstances that a case has been made out for an injunction, and the motion must be refused.'

IN RE THE LONDON AND GENERAL BANK LTD. (1895)

The first case brought under the misfeasance provision was in re London and General Bank Ltd. [1895]. The Court of Appeal had already decided in an earlier hearing of the summons in connection with this liquidation that the Auditor of a banking company was an officer within the meaning of the provision and therefore subject to misfeasance proceedings. The company was registered under the Companies Act, 1879, which provided for the compulsory audit of the accounts of banking companies, although an audit was not then required by statute in respect of companies carrying on other types of business.

The misfeasance alleged was the Auditor's neglect to bring to the notice of the shareholders the fact that the assets shown in the Balance Sheets of the company were over-valued, as a result of which dividends had been paid out of capital.

In the course of his judgment Lindley, L.J., said :—

> "It is no part of an Auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An Auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably' or unprofitably; it is nothing to him whether the dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question : How is he to ascertain such position? The answer is : By Examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than a farce....

"His first duty is to examine the books, not merely for the purpose of ascertaining what they do show but also for the purpose of satisfying himself that they show the true financial position of the company. An Auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position on the company's affairs; he does not guarantee that his balance sheet is accurate according to the books of the company. If he did, he would be responsible for an error on his part, even if he were himself deceived, without any want of reasonable care on his part—say by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the Auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care is any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little enquiry will be reasonable and quite sufficient; and in practice, I believe business men selected a few cases haphazard, see that they are right, and assume that others like them are correct also. When suspicion is aroused, more care is obviously necessary; but still, an Auditor is not bound to exercise more than reasonable care and skill, even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required ....

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more. Information and means of information are by no means equivalent terms.... an Auditor who gives shareholders means of information, instead of information, in respect of a company's financial position, does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty.

"In this case I have no hesitation in saying that Mr. Theobald did fail to discharge his duty to the shareholders, in certifying and laying before them the balance sheet of February, 1892, without any reference to the report which he laid before the directors, and with no other warning than is conveyed by the words, 'The value of the assets as shown on the balance sheet is dependent upon realisation.' The most important asset on the balance sheet is put down as 'Loans to Customers and other Securities £346,975,' and on these a full and detailed report was made to the directors showing the very unsatisfactory state of these loans and securities.... It is a mere truism to say that the value of loans and securities depends upon their realisation. We are told that a statement to that effect is so unusual that the mere presence of those words is enough to excite suspicion. But, as already stated, the duty of an Auditor is to convey information, not to arouse enquiry, and although an Auditor might infer from an unusual statement that something was seriously

wrong, if by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expenses no more than any ordinary person would infer without it."

The following remarks are from the judgment of Rigby, J.L.:—

"The Articles of Association cannot absolve the Auditors from any obligation imposed on them by statute....

"The words 'as shown by the books of the company' seem to me to be introduced to relieve the Auditors from any responsibility as to affairs of the company kept out of the books and concealed from them, but not to confine it to a mere statement of the correspondence of the Balance Sheet with the entries in the books. Now, a full and fair Balance Sheet must be such as to convey a truthful statement as to the company's position. It must not conceal any known cause of weakness in the financial position, or suggest anything which cannot be supported as fairly correct in a business point of view.

"It was the duty of the Auditors to convey in direct and express terms to the members any information which they thought proper to be communicated.... It is no part of the Auditors' duty to consider what is good or what is bad policy. They have only to examine into facts and see that the members have their opinion as to the Balance Sheet showing the state of the affairs of the company. The Balance Sheet, as it stands, would have given no hint to any ordinary reader of the critical position. In reporting this Balance Sheet without explanation, the Auditors were, in my judgment, guilty of a misfeasance."

The Auditor was ordered to pay in to the company's funds the amount of one of the dividends wrongfully paid, together with interest.

[The words "full and fair Balance Sheet" constituted part of the formula of the normal audit report prior to 1900, the words being used in the clause of Table A stating the duties of the Auditor, when one was appointed under the Articles.]

IN RE THE KINGSTON COTTON MILL CO. LTD. (1896)

In the Kingston Cotton Mill [1896] case, dividends had been actually paid out of capital on the faith of Balance Sheets which showed available profits by reason of the over-valuation of the stocks on hand. The manager of the company had for several years fraudulently bolstered up the Balance Sheets to make the company appear flourishing instead of the reverse. The Auditors took the value of the stock-in-trade at the end of each year from the Stock Journal which contained a number of accounts and a summary of all the accounts showing the total value; the summary was signed by the manager, and the value was adopted by the Auditors and entered in the Balance Sheet with the note "as per manager's certificate." The summary always corresponded with the accounts summarised and the Auditors checked this, without however examining further into the accuracy of the accounts summarised.

In an earlier summons in the case of this company the Court of Appeal had held that the Auditor was an officer, notwithstanding that an audit was not compulsory by statute; the audit was prescribed by the Articles, but it was considered that no distinction arose between the case of the company and that of the London and General Bank.]

During the course of his judgment Lindley, L.J., said :—

> "I protest against the notion that the Auditor is bound to be suspicious, as distinguished from being reasonably careful. To substitute the one expression for the other may lead to serious error.... The Auditors did not profess to guarantee the correctness of this item [the stock]. They assumed no responsibility for it. They took the item from the manager, and the entry in the Balance Sheet showed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of the Auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade in hand. In the case of a cotton mill he must rely on some skilled person for the materials necessary to enable him to enter the stock-in-trade at its proper value in the Balance Sheet....
>
> "The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the Auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such person was essential. I cannot think that there was."

From the judgment of Lopes, L.J :—

> "It is the duty of an Auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious Auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An Auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.... The duties of Auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate.... Auditors must not be made liable for not tracking out ingenious and carefully-laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors. So to hold would make the position of an Auditor intolerable."

The famous metaphor of Lopes, L.J., as to the duty of the Auditor that "He is a watch-dog, but not a bloodhound," has been criticised and expanded from time to time in the judgments of various Courts. Thus in the Canadian case, International Laboratories Ltd. v. Dewar and Others [1932], it was said :—

> "As I understand it, the useful work of a watch-dog is based on the fact that he is expected, particularly if he be in the dark, to raise an alarm whenever he sees or hears anything unusual, and, if a possible marauder appears to be approaching, to continue his combined protests and threats with two objects in view : (1) that the cause of the fancied threat may be withdrawn; and (2) that his master may be aroused to his danger; and only when one of these objects has been accomplished will he be considered to have discharged the duties of the position which he assumed. He will not have performed the functions of his office if after one howl he retreats 'under the barn', or if he confines his protest to a fellow watchdog."

IN RE CITY EQUITABLE FIRE INSURANCE CO. LTD. (1926)

In this case [1924], charges were made against the Auditors of the company of negligence in respect of the audit by them of the accounts of the company for certain years. It was sought to make them liable to pay to the liquidator compensation for the loss sustained by reason of the alleged negligence.

The charges came under the three following heads :—

(i) Their misdescriptions in the Balance Sheets of the debts of Ellis & Co. and Mansell, by including them under "Loans at call or short notice" or "Loans" or in the case of part of Ellis & Co.'s debt, under the heading of "Cash at bank and in hand," and their consequent failure to disclose to the shareholders the existence of those debts.

[Mansell was the general manager of the company and Ellis &Co. were the company's stockbrokers. G.L. Bevan was the chairman and driving force of the company and was also the principal partner in Ellis & Co. He was convicted of fraud in relation to the company's balance sheets and sentenced to penal servitude.]

(ii) Their failure to detect the fact that much larger sums were in the hands of Ellis & Co. at the date of each of the balance sheets than were so included. Just before the end of each of the years in question large blocks of Treasury Bills were purchased and as much as possible borrowed against them; immediately after each year-end the securities were sold and the loan paid off.

(iii) Their failure to detect and report to the shareholders the fact that a number of the company's securities, which were in the custody of Ellis & Co., were being pledged by that firm to its customers.

In the Chancery Division the Auditor was considered to have been guilty of misfeasance only under the third head above but was able to claim protection under an immunity clause in the Articles. [Such clauses are now void under section 205, Companies Act, 1948.] The Court of Appeal entirely approved the findings as regards the first two points, but there was some doubt expressed by two members of the Court as to whether there had actually been negligence in relation to the securities; but as it was definitely decided that the Auditor was in any case immune under the Articles the matter was not further discussed.

As to the misdescriptions, the general conclusions were that "even if the misdescriptions did amount to negligence, it caused no damage to the company."

As to the "window-dressing" the view was that if the Auditor's duty had been confined to the Treasury Bills Account the suggestion that he should have detected the arrangement would be understandable; but considering the magnitude of the task each year the suggestion of negligence could not be maintained.

In regard to the securities the Auditor had obtained certificates from the stockbrokers as to the securities held by them. As to this it was said in the Chancery Division judgment :—

> "An Auditor is not in my judgment ever justified in omitting to make personal inspection of securities that are in the custody of a person or company with whom it is not proper that they should be left. Whenever such personal inspection is practicable, and whenever an Auditor discovers that securities of the company are not in proper custody, it is his duty to require that the matter he put right at once, or, if his requirement be not complied with, to report the fact to the shareholders, and this whether he can or cannot make a personal inspection. The securities retained in the hands of Ellis & Co. for periods long beyond the few hours in which securities must necessarily be from time to time in the possession of the company's stockbrokers were not in proper custody. That Ellis & Co. were at all material times regard, and reasonably regarded, by Mr. Lepine [the Auditor] as a firm of the higher integrity and financial standing is not to the point. A company's brokers are not the proper people to have the custody of its securities, however respectable and responsible those brokers may be. There are, of course, occasions when, for short periods, securities must of necessity be left with the brokers, but the moment the necessity ceases, the securities should be lodged in the company's strong room or with its bank, or placed in other proper and usual safe keeping. In my judgment, not only did Mr. Lepine commit a breach of his duty in accepting, as he did from time to time, the certificate of Ellis & Co. that they held large blocks of the company's securities, but he also committed a breach of his duty in not either insisting upon those securities being put in proper custody or in reporting the matter to the shareholders."

In the Court of Appeal this view was not entirely accepted as may be seen in the following passages from the judgments :—

> "What I think the witnesses meant to express was this : Banks in ordinary course do hold certificates of securities for their customers; it is part of their business, and therefore certificates in the hands of bankers are in their proper custody, and if then the bank is a reputable bank, a bank which holds a high position, you may legitimately accept the certificate of that bank.... But the fact that it calls itself a bank does not seem to me to conclude the matter either one way or the other.... It is going too far to say that under no circumstances may you be satisfied with securities in the hands of a stockbroker, because... in the ordinary course of business you must from time to time, and you legitimately may, place in the hands of stockbrokers securities for the purpose of their dealing with them in the course of their business.... I think he [an Auditor] must take a certificate from a person who is in the habit of dealing with and holding securities, and who he on reasonable grounds rightly believes to be, in the exercise of the best judgment, a trustworthy person to give such a certificate."

The duty of an Auditor was described by Lord Justice Sargant as "verification and not detection," and by Lord Justice Warrington in the following words :—

> "The duty of an Auditor is to verify the facts which it is proposed to state in the Balance Sheet and to verify them using ordinary and reasonable care and skill."

IN RE WESTMINSTER ROAD CONSTRUCTION AND ENGINEERING CO. LTD. (1932)

This case [decided 1932] was concerned largely with the matter of work-in-progress as disclosed on the Balance Sheet, as a result of the over-valuation of which item, and the understatement of the liabilities, a dividend was paid out of capital and commission on profits was paid to a director.

On behalf of the Auditor it was put forward inter alia that his duty was to be performed by an examination of the books, and he was not responsible for liabilities or other matters not in the books and not reasonably brought to his notice; that he was entitled to rely on information and explanations from a responsible official if there were no reason to doubt their accuracy and that he was not bound to take any further step to verify this matter even though known means of doing so existed; and that it was not his duty to go through the minutes, letter books, or files (which would have disclosed information as to the inflation and omissions), to see whether there might be evidence of liabilities or other material matters not disclosed in the books.

It was decided that the Auditor had failed in his statutory duty; his duty with regard to unrecorded liabilities must depend on the facts of each particular case, the nature of the business, and the practice of the suppliers of the company as regards sending out invoices. It was the Auditor's duty to make specific inquiries as to the existence of liabilities for which

invoices might not have been received, and to go through the invoice files to see that none were omitted. It was also the Auditor's duty to see that nothing was included in work- in-progress which had actually been done after the date of the accounts. The liquidator of the company was entitled to recover the amount improperly paid away, together with interest and costs.

IN RE ALLEN CRAIG & CO. (LONDON) LTD. (1934)

This case raised an attempt to extend the duties of Auditors under section 134(1), Companies Act, 1929. The liquidator of the company took out a summons for misfeasance against the former managing director and the Auditors asking for a declaration that such parties were liable for the debts of the company incurred after 30th June, 1925. The Court held that the director was liable for the debts incurred after 1st November, 1929 (when section 275, Companies Act, 1929, as to fraudulent trading came into operation), but discharged the Auditors.

The company (capital £10,000) made a loss in each year of its existence, and there was as deficiency of assets to meet liabilities of over £40,000. In submitting the accounts for the year to 30th June, 1924, the Auditors sent a letter to the company drawing attention to the serious position of the company, this being quite apart from the normal audit report. In 1927 in submitting the accounts for the years to 30th June, 1925 and 1926 respectively, the Auditors sent further letters, showing that there was a deficiency as regards creditors of nearly £11,000.

The following passages from the judgment are of interest:—

> "Whether these letters [referred to above] were, or were not, received at the time it was plain beyond dispute that they were in the hands of Mr. Allen by 20th December, 1929.
>
> "No other conclusion was possible than that Mr. Allen was liable under section 275 of the Companies Act in respect of debts incurred.... No complaint was made of the skill with which they [the Auditors] audited the accounts. If they were liable under the Companies Act it was merely because they did not know of the obligations imposed upon them by the Act. Before it could be held that a man was guilty of breach of duty it must be possible to define the duty.... The important section was 134 of the Companies Act of 1929 which provided that 'every Auditor shall make a report to the members on the accounts examined by them'.... In respect to these two balance sheets [1925 and 1926], what was the duty of the Auditors? All the Auditors did with them was to send them to the secretary of the company. They never got beyond the secretary of the company. The directors never caused a general meeting of the company to be held for the purpose of considering these two balance sheets and the reports annexed thereto.... The members

of the company never saw the reports of the Auditors on these balance sheets.

"Did the statute impose on Auditors the duty of making their report to every member of the company? It the words of section 134(1) was given their plain meaning it would seem that that obligation was imposed. It could not have been the intention of the Legislature to impose that duty on Auditors and it certainly never had been the practice... Mr. Christie.... said 'members of the company' meant all members of the company, but that these were represented by members present in general meeting. Therefore, if the report were presented at the general meeting the duty was complied with. If, on the other hand, there was no general meeting called by the directors, then Mr. Christie argued that members of the company meant all the members, because the section did not say the words meant less.... The words must have some one meaning throughout. The meaning of them could not be changed according to whether or not the directors chose to call a general meeting. If would not be possible to hold that members in section 134(1) meant all the members, because it could not be that Auditors were to be at the expense and trouble not merely of sending their reports through the post, but of delivering them to every member of the company. If the duty were absolute, sending copies through the post might not be sufficient. Therefore, circumstances made it necessary to limit the meaning of the word members as found in the section. The limitation that ought to be placed upon them was 'members assembled in general meeting.'

"The next thing was to decide whether the Auditors were under some duty that it might be impossible for them to perform. It could not be right to say that. If the duty were to report to members in general meeting, it was not possible to say that it was the duty of Auditors to make that report themselves—unless they could themselves call a general meeting or compel somebody else to call a general meeting. There were no means by which Auditors could themselves convene a general meeting. Nor were there means by which they could compel others to do so.... All these considerations forced one to the conclusion that the duty of Auditors, having affixed their signature to the report attached or annexed to the balance sheet, was confined to sending that report to the secretary of the company, leaving the secretary or the directors to perform the statutory duty of convening a general meeting to consider the report. It was the duty of directors to see that the Auditor's report was read at such meeting.

".... The statute compelled directors to convene a meeting of shareholders once a year. It compelled the directors to present reports to the general meeting of shareholders. It compelled the directors to have the Auditors' reports read to the meetings. If the shareholders had not the will or the determination to exercise their rights that did not seem to be any reason for enlarging the duties of Auditors."

IN RE S.P. CATTERSON AND SONS, LTD. (1937)

No broad principal arose in re S.P. Catterson and Sons, Ltd. [1937], but the case is of interest in that the judgment contains some important observations on the responsibility of the directors. A further point is that whilst the defalcations on which the summons was based related to the years 1929 to 1932 and were discovered in the latter year, no action was suggested against the Auditor until after the company had been in liquidation for a year; in fact, after the discovery the Auditor was twice re-appointed, so that it is evident that the directors and/or shareholders had not considered the Auditor to have been negligent.

The misfeasance alleged against the Auditor was negligence in failing to discover misappropriations by a show-room employee of the company of moneys received in respect of cash sales.

> ". . . . the primary responsibility for the accounts of a company is with those who are in control of the company, that is to say, the directors. . . . It is their duty in the first place to keep the company's accounts, and to prepare the accounts which have to be submitted to the company in general meeting. . . . It is for the directors to manage the business in the way in which they think best in all the circumstances of the case, including in the management of the business the system of accounting to be employed."
>
> ". . . . once a fraud has been discovered it is extraordinarily easy to see indications of its sticking out everywhere. . . indications which are not always apparent, or not necessarily apparent, to a man who is dealing with another on the footing that that other is not a dishonest man. . . ."

The learned judge then proceeded to deal with the defects in the cash sales system, mixed up as it was with sales on short-term credit, which had made the defalcations possible, and that the "so-called system of keeping a record of the transactions done on credit by turning down the invoice was known to the directors and had been known to them for years."

> "What is charged against them [the Auditors] first of all is that they omitted to provide an efficient system of verifying the cash received. . . . in respect of sales from the company's showroom. . . . It is clear that [the Auditor] did want an alteration in the system which was employed. . . . and [the managing director] objected because either it was too expensive or it was too cumbersome. . . . The unsatisfactory system employed was present to the mind of [the accountant] and . . . it was called by him to the notice of the directors. . . they preferred to continue the system as it was. I am not prepared to hold, in those circumstances and on those facts, that there was any duty upon the Auditors to insist upon that system being changed. It is not their business to tell the directors how to carry on and conduct their accounting system; they make their recommendations, and if they are not acceded to, the responsibility is not the Auditor's responsibility, but it is the responsibility of the directors."

"The primary responsibility for finding out the defalcation. . . lies upon the shoulders of the man whose duty it was, as a director of the company, to collect from [the person responsible for the defalcations] the cash that he received;. . . it is those people who have failed to discharge the duty they owed to the company, and not the Auditors".

NEWTON V. BIRMINGHAM SMALL ARMS CO. LTD. (1906)

The case of Newton v. Birmingham Small Arms Co. Ltd. [1906] mainly concerned a proposal to restrict the statutory powers of the Auditors of the company by an amendment of the Articles, but incidentally to this the subject of secret reserves and their propriety was dealt with at length.

The company by special resolution amended its Articles by introducing provisions as to an internal reserve fund; it was provided that the directors should disclose all the facts as to this reserve fund to the Auditors, who were not, however, to be permitted to disclose any information in regard to it to the shareholders. It was held that the Article was ultra vires to the extent that it restricted the powers of the Auditor, since such restriction was contrary to the Companies Act provisions as to Auditors. In the course of the judgment it was said:—

> "The concluding sentence . . . requires that the Auditor shall state whether the Balance Sheet exhibits a true and correct view of the state of the company's affairs as shown by the books. [It was] argued that these words are satisfied if the Auditors report that the Balance Sheet does not exhibit a true view and that the statute does not, in these words, say that they shall report what is the true view. . . .But . . . words earlier in that section . . . provide that the Auditors are to report to the shareholders on the accounts. A report upon the accounts involves a report of the result of the accounts. . . . the statement of a Balance Sheet or the equivalent of a Balance Sheet . . . to the accuracy of which the Auditors shall speak. The special resolutions in the present case provide that the Balance Sheet shall not disclose the internal reserve fund. It must therefore omit. . . the assets which make up . . . the fund and the contra item . . . on the liability side. The result will be to show the financial position of the company to be not so good as in fact it is. If the Balance Sheet be so worded as to show that there is an undisclosed asset, the existence of which makes the financial position better than shown, such a Balance Sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament.
>
> "Assets are often, by reason of prudence, estimated, and stated to be estimated, at less than their probably real value. The purpose of the Balance Sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not, or may not be, better. The provision as to not disclosing the internal reserve fund in the Balance Sheet is not, I think, necessarily fatal to the special resolutions. . . . But the special resolution do not stop there. They provide that it shall be the duty of the

Auditor not to disclose any information with regard to this fund to the shareholders or otherwise. It is, I think, inconsistent with the Act of Parliament that the Auditor shall be bound, even when he thinks that the true state of the company's affairs is affected by facts relating to the internal reserve fund, to withhold all information with regard to the same from the shareholders. If, for instance, the directors had invested the internal reserve fund upon investments which might involve the company under certain circumstances in enormous loss, the Act, I think, requires that the Auditor shall be at liberty and be bound to report that fact. In reporting upon the accounts submitted to them the Auditors do not, of course, report as to the details of the accounts to which they find no cause to take exception. Their duty is to call attention to that which is wrong, not to condescend upon all the details of that which is right. It is, I think, competent to the statutory majority of the shareholders to say that as to particular items of their business, it is to the interest of the corporation that there shall be secrecy and that the Auditors, who must for the purpose of their audit know all such details, shall not, unless their duty under the statute requires it, disclose such details to the members. There is no suggestion in this case that these clauses are intended to be used for any other than a legitimate purpose. Those who are engaged in commerce are familiar with the fact that undue publicity as regards the details of their trade or as to the financial arrangements, may often be injurious to traders, having regard to the rivalry of competitors in trade, to complications sometimes arising from strained relations between capital and labour, and the like. There are legitimate reasons for ensuring secrecy to a proper extent. It is not, I think, necessary, nor, having regard to the great utility of these Acts, is it desirable, to expose persons who trade under these Acts to the necessity of a publicity from which their competitors are free, unless such publicity is required to ensure commercial integrity. I am not disposed to look too closely for reasons why I should find clauses such as these to be inconsistent with the Act if I see that the true purpose of the Act is satisfied. I think, however, these special resolutions go too far. Any regulations which preclude the Auditors from availing themselves of all the information to which, under the Act, they are entitled as material for the report, which, under the Act, they are to make as to the true and correct state of the company's affairs, are, I think, inconsistent with the Act."

The validity of the observations in this case as to the propriety of the maintenance of secret reserves does not appear to have been affected in any way by the judgment in Rex v. Kylsant and Another [1931], which in respect of this matter dealt with the non-disclosure of the protracted utilisation of such reserves.

SPACKMAN V. EVANS

The case of Spackman v. Evans [1868] primarily concerned the placing of the names of shareholders on to the list of contributories on a liquidation, but the position of the auditors was also discussed in the judgments in the House of Lords. The following are relevant observations :—

> "It was said that all the facts must have been known to the Auditors, and that they being appointed by the shareholders must be treated as their agents. The Auditors may be the agents of the shareholders so far as relates to the audit of the accounts. For the purpose of the audit the Auditors will bind the shareholders and. . . it may be said that any special matter contained in their report as to the state of the accounts and the assets of the company must be considered as having come to the knowledge of every shareholder.
>
> ". . . the two Auditors (after the first two) are to be appointed by the shareholders at an annual general meeting. It seems to me that it would be an unreasonable conclusion, from this mode of appointment of these officers, that they were thereby constituted agents so as to conclude the shareholders by their knowledge of any unauthorised acts of the directors. It would be no part of their office to inquire into the validity of any transaction appearing in the accounts of the company."

LONDON OIL STORAGE COMPANY LIMITED V. SEEAR HASLUCK AND COMPANY

Action against Auditor—Shortage in steadily increasing cash balance not discovered—Omission to verify the assets 'cash-in-hand'—Breach of duty of Auditor—Nominal damages.

This case was decided before the Lord Chief Justice and a special jury, in the King's Bench Division, on the 1st June, 1904.

It was held to be the duty of the auditor of a company to take proper steps to verify the existence of assets stated in the Balance Sheet.

The case consisted of an action for damages for alleged negligence in auditing the plaintiff company's accounts. The defendants denied that they had been guilty of negligence, and said that the alleged loss of £760 had been caused by negligence on the part of the directors of the plaintiff company in entrusting so much money to their cashier.

The defendant had been the auditor of the company from the first, and it was his duty under the articles to audit the accounts and 'to certify the correctness of the financial statement' for the purpose of the yearly Balance Sheet, in which there appeared a sum representing cash-in-hand, and it was in reference to that sum that the plaintiffs alleged that Mr. Hasluck, through his clerks, had been guilty of negligence. One of the officials of the company had been a Mr. Frederick R. Clarke, who had been taken over from Mrs. Ingall when the company was

formed, and who had at first been book-keeper and cashier, but was later also appointed secretary at the city office. At that office a Petty Cash Book was kept, in which the cash balance appeared, and Mr. Hasluck's clerks entered in the Balance Sheet the amount of petty cash that appeared in the Petty Cash Book, but they never troubled to find out whether Mr. Clarke had that balance in hand or not. Till 1902 nothing was suspected, but Mr. Clarke was then seized with a paralytic stroke and had ever since been in a pitiable state, and could not be called as a witness. His duties were taken over by Mr. Hubble, who found in the cash box about £30, though the Petty Cash Book showed a balance of £796, the balance having gradually increased from £21 in 1897 to £796 in 1902.

The jury returned a verdict to the effect that there was a breach of duty in 1899, 1900, 1901, and 1902, and that there was damage to the extent of £5 5s. The jury added that they considered that the directors had been guilty of gross negligence.

In the course of his judgment, the Lord Chief Justice said :

> '. . . I would call attention to the fact that the jury have, I think rightly, limited their finding to the years 1899, 1900, 1901, 1902, when the asset was a substantial sum of money not less than £470 in the first year . . . . I am bound to say that I think that there was a very grave and substantial question to be fought and tried, which the jury have answered, in my opinion, absolutely rightly, that there was not a sufficient fulfillment of his duty in ascertaining whether that asset really existed. I particularly desire to avoid using the words "counting the cash". I do not think that is a true statement of the duty of an auditor, although it is one way of putting it. Anything may be "counting cash", if you ascertain it is there; but, as I tried to point out to the jury, there may be cases in which the actual counting of the sovereigns is not even the best way of vouching or ascertaining the amount. Therefore I think the jury did take the view properly that there was not a proper discharge of his duty by his clerk—nothing morally wrong in the least, but not a sufficiently careful supervision by Mr. Hasluck's clerk of the asset which was believed to exist, and which was shown by the books to exist, because that the audit was most carefully performed I have not a shadow of doubt apart from this. I think there was a substantial issue properly raised by the plaintiff and properly defended by Mr. Hasluck, if he determined to fight the battle on the ground on which he did fight it, that there was no duty on an auditor to ascertain the existence of an asset, assuming the books showed that asset ought to have been in existence. Therefore, I think a substantial question had to be tired, and that entirely makes it impossible for me to say that there was not an issue before the jury as to breach of duty, and, if it were a breach of duty, at any rate there must be nominal damages.'

ARMITAGE V. BREWER AND KNOTT (1932)

Detailed Audit contracted for—Defalcations in petty cash transactions and time-sheets not detected in Audit—Auditors held negligent.

Decided by Mr. Justice Talbot in the King's Bench Division on 15th December, 1932.

This was an action by Mr. Joseph Armitage, an architectural designer and sculptor, against Messrs. Brewer and Knott, a firm of chartered accountants, for alleged negligence in auditing as a result of which defalcations of over £1,400 were not detected.

A lady employed by the plaintiff (Miss Harwood) was prosecuted in December, 1931, pleaded guilty and was sentenced to 15 months' imprisonment. Miss Harwood became secretary, book-keeper and cashier to Mr. Armitage in April, 1929, and he then ascertained to his surprise that the defendants had only been balancing the books and getting out the accounts for income-tax purposes, but had not been auditing. A periodic audit with a master audit at the end of the year was then arranged for at a fee of 50 guineas, and Mr. Armitage was willing to pay that fee to protect him against irregularities and loss.

The chief trouble was fraudulent time sheets which comprised most of the defalcations of £1,400. In addition, there were petty cash irregularities, caused by duplication of entries of some £60.

Mr. Justice Talbot, in the course of his judgment, pointed out that Mr. Armitage had to conduct his studies and a large business and he must have a way of escape from the distraction and annoyance of uneasiness as to whether his accounts were properly kept. The documents showed that the defendants would vouch all payments with receipts in petty cash, check calculation and additions of all wages sheets, check totals of wages sheets into wages book and check weekly totals with other detailed provisions, and accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was a small matter; they undertook a rigorous check, and they did so because that was what their client wanted. He told them he wanted protection against petty frauds. The defendants knew uncontrolled powers were committed to the person in the office Miss Harwood filled. They did not refuse the audit because of a risk of employing one woman in that kind of position. What was required of them in the circumstances entailed more laborious work and more vigilance. They undertook that work and the reassurances Mr. Armitage frequently asked for, they gave. That was a sufficient account of the duty they undertook.

Had it been performed with the care they owed the plaintiff and which could be expected under their retainer from competent and upright professional people ? His lordship thought the

answer was that it had not. However much it might be wrapped up, the defendants' case came to this, that systematic fraud for 2½ years by one person, could not be detected by the exercise of reasonable care of the accountants. His lordship did not like to use strong language, but that appeared to him to be bordering closely on nonsence. On the evidence it was an allegation which did not bear a moment's examination. It was doubtless true that to detect required minute examination of a large number of documents, but that was exactly what the defendants undertook to do. To examine only a sample of the time sheets his lordship thought contrary to the terms of the statement he had indicated. But the point was that to the vouchers they did examine, the defendants did not bring proper care. It was no use looking at documents unless one did it with scrupulous accuracy. The suggestion that something was the kind of thing a junior clerk would have passed was an unjust imputation on junior clerks. But if junior clerks could not do the work, they must be got rid of; auditors could not get rid of their responsibility by delegating it to junior clerks.

In the matter of the duplication in the petty cash of Cole's disbursements, there was no suggestion against Cole of dishonesty, but a very moderate amount of inquiry and care should have detected these double entries when they began. That a multitude of time sheets were fraudulent was admitted. His lordship was satisfied that if the defendants has done their duty before the time sheets came into the case, Miss Harwood would have gone and there would have been an end of her frauds. It was clear that a good many documents were suspicious on their face and called for inquiry. The defendants seemed to have been content to treat the time sheets as simply a matter in respect of workman and foreman—to guard against fraud there—but the time sheets turned out to be the largest part of the money frauds Miss Harwood committed.

His lordship entered judgment for the plaintiff for £1,250.

REX V. KYLSANT AND MORLAND (1931)

Criminal proceedings were taken against the chairman and the auditor of the Royal Mail Steam Packet Co., Ltd., under the Larceny Act, 1861, the allegation being that the chairman had issued false annual reports to the shareholders with intent to deceive, and that the auditor had been guilty aiding and abetting in the issue of such false reports. Both the chairman and the auditor were acquitted of this charge, but the chairman, on a further charge, was found guilty of publishing a prospectus which he knew to be false in a material particular.

For some years the Royal Mail Co. had incurred actual trading losses, but their published accounts revealed considerable profits available for dividend. This position was largely brought about by the utilisation of taxation and other reserves created in past years and no

longer required for the purposes for which they were made. These reserves were secret reserves, inasmuch as they were not disclosed in the accounts, and the only indication of the fact that such reserves were being transferred to the profits of the years in question were the words "after adjustment of taxation reserves" included in the omnibus item of income shown to the credit of the published Profit and Loss Account. It was shown that during the years 1921-1927 no less than £50,00,000 taken by the company to the credit of its Profit and Loss Accounts was the result of drawing upon secret reserves or taking credit for such non-recurring items as bonus shares received. It was alleged by the prosecution that the result of such adjustments was to cause shareholders to believe that the company was trading profitably, whereas in fact it was making losses.

In the course of his opening remarks the Attorney-General said that when an auditor signed accounts, and stated "to the best of my information this Balance Sheet is properly drawn up so as to exhibit a true and correct view of the company's affairs as shown by its books" he was stating something upon which the ordinary investor was entitled to rely.

The auditor was charged under section 84, Larceny Act, 1861, with aiding and abetting in the circulation of a written statement or account which he knew to be false in a material particular. In this connection, Wright, J said, in the course of his summing-up—

> "What exactly does that mean ? The conclusion I have arrived at is this — that it is not limited to a case where you point to a written statement or account and say, 'Here are certain figures and words which are false.' I think that is to narrow unduly the words 'in any material particular'. If it is true in that way it would shut out the type of fraud in connection with written documents and accounts which may be of the utmost importance—the type of fraud where you have a document, not fraudulent in the sense of what is states, but in the sense of what it conceals or omits.
>
> "I think the language which is used means more than that. It will cover the case where you have a written statement or account which is false in no specific words or figures which it contains, but which is false in the way in which it may be formed.
>
> "You may say, referring to every word and every figure, there is nothing false about this or that, but the document as a whole may be false, not because of what it states, but because of what it does not state and because of what it implies.
>
> "Of course, that type of falsity, which is indeed the type of falsity in question here, is more difficult to establish than a case where you can point to a specific false word in a sentence. Where the falsity consists in fraudulent design to create a false impression you have got to show affirmatively that there was a deliberate attempt to create a false impression.
>
> "If you have a definite falsehood then that speaks for itself."

Mr. Justice Wright pointed out that the section involved three things—a false written document, knowledge of the falsity by the person who put it forward, and intent to deceive.

Little was said at the trial about the Balance Sheet of the company, the main allegation being that the Profit and Loss Account contained information which was false in that it included "old" reserves without that fact being disclosed.

In his summing-up Wright, J.; made the following remarks in connection with secret reserves—

> "We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding, in order to find out and elucidate these very special matters. It was said by a learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in a secret disposition of the managing authority. It may work very well in many cases; to doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all?"

With regard to the use of the words "adjustment of taxation reserves" Mr. Justice Wright said—

> "Is this phrase sufficient ? Is it a proper intimation to the shareholder in the year 1926 of what has been going on in the company's affairs, in order to produce year by year, not only debenture interest and the interest, discounts and other things, but the preference dividend and the ordinary dividend?.....I am reminding you, although I am sure you have it in your minds, that it is my duty to remind you of what appears to me to be the first question you have to consider, granting all this, was it false and misleading in all the circumstances to put forward to all the shareholders in the Balance Sheet* merely these words 'adjustment of taxation reserves,' as a warning that these enormous sums were being drawn from these funds, the nature of which I must consider a little later ?"

In connection with the auditor's position in regard to secret reserves, the Judge said—

"If the accounts from which the dividends were being paid or the expenses were being met were being fed by undisclosed reserves, it seems very difficult to see how an auditor could discharge his duty of giving a true and accurate view of the correct state of the company's affairs without drawing attention to those facts, which were vitally important.

"No doubt an auditor in his important and delicate duties must use a certain amount of discretion, but whatever discretion he may feel, justified in exercising, he must remember he is under statutory duty, and he may come under the penalties of law, if he fails in that duty...

"The auditor is not concerned with questions of policy, but if he sees that there is something in the accounts to which he ought to draw the attention of the shareholders it is his duty to do so. Either he will not sign the certificate at all or he will sign it with some qualifications such as circumstances require.

"The question is not whether the two defendants or either of them have committed any breach of duty to the company, either as chairman or auditor. If a breach of duty has been committed in connection with the accounts, if there has been any negligence, anything for which he directors or auditor may be liable to the company, then that is a matter directly and entirely beyond your purview and consideration.

"You are not here dealing with questions of civil liability. For civil liability the appropriate remedy is an action for damages."

APPENDIX III

QUESTION BANK

I. Nature of Auditing

1. Comment on the following statements:
   (a) Auditor is responsible for expressing opinion on financial statements in statutory audit. [May, 1995, Question 1(a); 6 marks]
   (b) "An auditor is responsible for the detection of errors and frauds."
   [Dec, 1999, Question 1(d); 4 marks]
   (c) "An opinion expressed by the auditor is neither an assurance as to the future viability of the enterprise nor the efficiency or effectiveness with which management has conducted the affairs f the enterprirse." [May, 2000 Question 4(b); 6 marks]
   (d) "Auditor's professional responsibilities are governed by basic principles which should be complied with whenever an audit is carried out."
   [Nov, 2002 Question 3(b); 10 marks]
2. State briefly six important aspects to be considered by an auditor while conducting an audit. [May, 1996, Question 2(a); 6 marks]
3. What in your opinion are the basic principles which govern the auditors professional responsibilities, whenever he carries out an Audit? [Nov, 1996, Question 1(a); 9 marks]
4. What would be the inherent limitations of an Audit in relation to frauds and errors?
   [Nov, 1996, Question 1(b); 9 marks]
5. Distinguish between Auditing, Accounting and Investigation.
   [May, 1999, Question 6(b); 10 marks]
6. State your opinion on the following:
   (a) "The duties of auditors are limited to the verification of the arithmetical accuracy of the books of accounts. [Nov, 1999, Question 2(a); 4 marks]
   (b) Some material misstatements remained unreported by auditors.
   [Nov, 1999, Question 2(c); 5 marks]

(c) "The audit of financial statements relieves management of its responsibilities."

[Nov, 1999, Question 2(b); 5 marks]

(d) "Auditor is entitled to rely on work performed by others."

[May, 2000, Question 2(a); 4 marks]

7. State briefly the basic principles which govern the auditor's professional responsibilities.

[Dec, 1999, Question 3(a); 6 marks]

8. What are the basic principles governing an Audit as laid down in SAP-1.

[Nov, 2000, Question 4(a); 10 marks]

9. 'After the statutory audit has been completed a fraud has been detected at the office of the auditee.' [Nov, 2000, Question 5(b); 4 marks]

10. 'Doing a statutory audit is full of risk.' [Nov, 2000, Question 5(c); 4 marks]

11. (a) Do you agree with the view that there are inherent limitations of Audit?

[Nov, 2001, Question 6(a), 8 marks]

(b) Mention briefly the conditions or events, which increase the risk of fraud or error leading to material mis-statement in Financial Statements.

[Nov, 2001, Question 6(b), 8 marks]

12. State with reasons your views on the following:

(a) The auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements.

[Nov., 2002, Question 1(a) 4 marks]

(b) The Auditor does not agree with affirmations made in the financial statements

[Nov., 2002, Question 1(b) 4 marks]

13. (a) "The auditors should consider the effect of subsequent events on the financial statement and on auditors report" according to SAP 19 – Comment.

[May, 2003, Question 3(a) 12 marks]

(b) Briefly explain the inherent limitations of audit.

[May, 2003, Question 3(b) 4 marks]

14. What are the methods of obtaining audit evidence?

[May, 2003, Question 5(a) 8 marks]

15. Mention any Twelve title of Statements on Standard Auditing Practices (SAPs) and the date from which it comes into force. [May, 2004, Question 4(b) 6 marks]

16. What are the auditor's responsibilities for detection of Frauds and Errors?

[Nov, 2004, Question 3(a) 8 marks]

17. State briefly the qualities of auditors. [Nov, 2004, Question 7(b), 4 marks]

18. (a) Explain with reference to the relevant Auditing and Assurance Standards:

(i) Inherent Risk (5 marks)

(ii) Appropriateness of going concern assumption (5 marks)

(b) State the matters to be considered for acquiring knowledge of the business of the client by the auditor. (6 marks)

[May, 2005, Question 7(a)&(b)]

Short Notes

(a) Continuous Audit [May, 1996, Question 8(a); 4 marks]

(b) Conditions or events which increase the risk of fraud or error

[May, 1998, Question 8(a); 6 marks]

(c) Errors of commission. [Nov, 1998, Question 8(d); 4 marks]

(d) Errors of Commission [May, 2001, Question 8(c), 5 marks]

(e) Operational Audit [May, 2002, Question 8(b), 4 marks]

(f) Substantive Procedures [May, 2004, Question 8(c), 4 marks]

(g) Initial Engagements [May, 2006, Question 8(c), 4 marks]

II. Basic Concepts in Auditing

1. (a) 'Disclosure of significant accounting policies adopted in the preparation of the financial statements enhance the intelligibility of financial statements.' Discuss.

[Nov, 1995, Question 1(a); 12 marks]

(b) What are the major considerations which govern the selection and application of accounting policies? [Nov, 1995, Question 1(b); 12 marks]

2. 'Materiality, being fundamental to the process of accounting, is an important and relevant consideration for the auditor.' Discuss. [Nov, 1995, Question 5; 16 marks]

3. "Independence of auditor must not only exist in fact, but should also appear to exist to all reasonable persons" – Discuss highlighting the advantages of an independent audit.

[May, 1997, Question 1; 18 marks]

4. What is 'Audit Evidence' and how it is obtained? [Nov, 1997, Question 1(a); 10 marks]

5. Briefly describe the Fundamental Accounting Assumptions.

[Nov, 1997, Question 1(b); 4 marks]

6. Distinguish between Internal Evidence and External Evidence.

[May, 1995, Question 3(c); 5 marks]

7. Distinguish between Internal Evidence and External Evidence

[May, 1998, Question 5(a)(i); 4 marks]

8. As an auditor, how would you react to the following situation?

The company produced photocopies of fixed deposit receipts as the original receipts were kept in the iron safe of the director finance who was presently out of the country on company basis. [Nov, 1998, Question 1(a); 4 marks]

9. Briefly state the audit procedures you will adopt in obtaining audit evidence.

[Nov, 1998, Question 2(a); 8 marks]

10. State your opinion on the following:

(a) "The auditor must gather sufficient competent evidential matter as a basis for forming his opinion." [Dec, 1999, Question 2(b); 4 marks]

(b) "Materiality is an important consideration for an auditor to evaluate whether the financial statements reflect a true or fair view or not."

[Dec, 1999, Question 2(c); 5 marks]

11. What is the importance of having the accounts audited by independent professional auditors? [May, 2001, Question 3(a), 8 marks]

12. (i) What is an "Audit Evidence"? [Nov, 2001, Question 7(I), 6 marks]

(ii) What are the various methods of obtaining audit evidence? Mention the same in brief. [Nov, 2001, Question 7(Ii), 6 marks]

(iii) Discuss the principles, which are useful in assessing the reliability of audit evidence. [Nov, 2001, Question 7(Iii), 4 marks]

13. Explain Accounting Policy giving few examples stating, why such policies be disclosed.

[Nov., 2002, Question 7(b), 8 marks]

14. Comment on the following:

"For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence as per SAP-22". [Nov., 2002, Question 3(a), 6 marks]

15. How would you proceed to check the misappropriation of cash in a trading concern?

[May, 2003, Question 5(b) 8 marks]

16. (a) What are the Basic Principles governing an Audit as laid down in SAP-1?

[May, 2003, Question 6(a) 10 marks]

(b) What are Audit working papers and why should they be carefully preserved by the Auditor? [May, 2003, Question 6(b) 6 marks]

17. What are the obvious assertions in the following items appearing in the Financial Statements?

(i) Profit and Loss Statement

Travelling Expenditure Rs.50,000

(ii) Balance Sheet

Debtors Rs.2,00,000 [Nov., 2005, Question 2(b) (i) & (ii) 2+2 marks]

18. (a) Under what circumstances change in accounting policies is permissible?

(b) What are the inherent limitations of audit?

[Nov., 2005, Question 3 (a) & (b), 8+8 marks]

Short Notes

(a) Reliability of Audit Evidence. [Dec, 1999, Question 8(b); 4 marks]

(b) Concept of Materiality in Audit. [Nov, 1996, Question 8(c); 4 marks]

(c) Analytical review. [Nov, 1998, Question 8(b); 4 marks]

(d) Disclosure of Accounting Policies. [May, 199, Question 8(c); 4 marks]

(e) Fundamental Accounting Assumptions. [Nov, 199, Question 8(ii); 4 marks]

(f) Substantive Procedures. [Nov, 199, Question 8(iii); 4 marks]

(g) Audit Evidence [May, 2000, Question 8(c); 4 marks]

(h) Preliminary Expenses [May, 2001, Question 8(a), 5 marks]

(i) Fundamental Accounting Assumptions [May, 2001, Question 8(b), 5 marks]

(k) Reliability of Audit Evidence [Nov., 2002, Question 8(c), 4 marks]

(l) Disclosure of Accounting Policies [May, 2003, Question 8(d), 4 marks]

(m) Fundamental Accounting Assumptions [Nov, 2003, Question 8(b), 4 marks]

(n) General Purpose Financial Statements [Nov., 2005, Question 8(a), 4 marks]

III. Preparation for an Audit

1. What are Audit Working Papers and why should they be carefully preserved by the auditor?

[May, 1996, Question 1(b); 6 marks]

2. What precautions are to be taken in the application of test-checking techniques?

[May, 1997, Question 3(a); 12 marks]

3. Mention any of the four items which are not suitable for test-checking

[May, 1997, Question 3(b); 4 marks]

4. Mention any four contents of the Permanent Audit File.

[Nov, 1997, Question 1(c); 4 marks]

5. What do you understand by 'Test checks'? [May, 1998, Question 1(a); 5 marks]

6. Distinguish between Audit Principles and Audit Techniques.

[May, 1998, Question 5(ii); 4 marks]

7. State your opinion on:

   (a) "The extent of checking to be undertaken is primarily a matter of judgement of the auditor." [Dec, 1999, Question 2(a); 5 marks]

   (b) In cases where audit sample selection has been done on a random basis, no statistical process for selection of samples need to be followed.

[May, 2000, Question 2(b); 4 marks]

8. "Statistical Sampling as a method of audit testing is more scientific than Judgement Sampling." Discuss. [Dec, 1999, Question 3(b); 6 marks]

9. (a) What audit points are to be borne in mind in the case of issue of Sweat Equity Shares by a limited company?

   (b) Explain the advantages of "Audit Working papers".

[May, 2002, Question 7(a) & (b), 18 marks]

10. What do you understand by 'Test Checks'? [May, 2002, Question 5 (b), 8 marks]

11. Adequate audit planning would result in efficient and timely Audit. Discuss.

[May, 2002, Question 6 (a), 8 marks]

12. "The audit firm should implement quality control policies and procedures." Explain.

[Nov, 2002, Question 6 (a), 8 marks]

13. Define the purpose of a 'Letter of Engagement' [May, 2003, Question 6(b) 8 marks]

14. In performing an audit of financial statements, the auditor should have or obtain knowledge of the business. Explain in the light of SAP-20.

[May, 2004, Question 3(a) 8 marks]

15. Explain the term "Auditor's Lien" [May, 2005, Question 4(a), 8 marks]

16. (a) What are the meaning and purposes of Sampling? Explain in the light of AAS-15, Audit Sampling.

(b) State briefly Audit Procedures and Audit Techniques

[May 2006, Question 7(a)&(b), 8+8 marks]

Short Notes

(a) Audit Risk and its Assessment. [Nov, 1996, Question 8(d); 4 marks]

(b) Permanent audit file. [May, 1997, Question 8(b); 4 marks]

(c) Audit Working Papers. [May, 1998, Question 8(c); 4 marks]

(d) Test Checking and Routine Checking. [May, 199, Question 8(b); 4 marks]

(e) Audit Risk. [Nov, 1999, Question 8(i); 4 marks]

(f) Stratified Sampling. [Nov, 2000, Question 8(d); 4 marks]

(g) Audit Note-book [Nov, 2001, Question 8(b), 6 marks]

(h) Continuous Audit – Advantages and disadvantages

[Nov, 2001, Question 8(c), 6 marks]

(i) Analytical Review [Nov, 2004, Question 8(a), 4 marks]

(j) Permanent Audit File [Nov., 2005, Question 8(b), 4 marks]

IV. Internal Control

1. Comment on the following statements:

(a) The statutory auditor is entitled to rely on the internal auditor.

[May, 1995, Question 4(b); 6 marks]

(b) The examination and evaluation of the internal control system is an indispensable part of the overall audit programme." [Dec, 1999, Question 2(d); 4 marks]

2. You have been appointed as Internal Auditor of a company and you have come across certain weaknesses in the Internal Control System. Draft a specimen form of Management Letter indicating at least four areas of weakness relating to Internal Control.

[May, 1996, Question 5; 16 marks]

3. State the steps that you would suggest for proper internal control over stores of a large Textile Mill company. [Nov, 1996, Question 5 16 marks]

4. You have been appointed auditor of a large Industrial Company which has an established Internal Audit Department. You are required to state:

   (a) The main aspects that would be considered to find out the effectiveness of the department.

   (b) The inter se relationship between the Statutory and Internal Auditor.

[Nov, 1997, Question 3(a) & (b); 7+9 marks]

5. Distinguish between Internal Check and Internal Audit

[Nov, 1997, Question 5(b), 5 marks]

6. What matters should be taken into consideration for evaluating Internal Control over after-sale-services? [Question 7(a); 6 marks]

7. Briefly enumerate the steps to assess the Internal Audit function of an enterprise.

[May, 1998, Question 1(c); 8 marks]

8. State briefly the audit objective of Review of the work performed by the different personnel of the Cash Department. [Nov, 1999, Question 3(a)(iii); 3 marks]

9. State General considerations in framing a system of Internal check.

[May, 2001, Question 3(b), 8 marks]

10. (a) What do you understand by the term "Government Audit"?

    (b) Explain briefly the approaches to EDP auditing.

[May, 2002, Question 3(a) & (b), 18 marks]

11. Both the Statutory and Internal Auditors shall be independent and not interdependent. Discuss. [Nov., 2002, Question 3 (b) 8 marks]

12. State the objectives of Internal Controls relating to Accounting system.

[Nov., 2002, Question 6 (b) 8 marks]

13. (a) Discuss the problems which are encountered while shifting from manual-based accounting records to computer-based accounting records.

[May, 1995, Question 4(a); 8 marks]

(b) What do you understand by Audit through the Computer'?

[May, 1995, Question 4(b); 8 marks]

14. (a) You have been appointed auditor for the first time of a small partnership firm carrying on business for last several years. What special information you would obtain before commencing the audit. ? [May, 1995, Question 5(a); 8 marks]

(b) What would be your duties and responsibilities towards its audit problems and how would you overcome them? [May, 1995, Question 5(b); 8 marks]

15. Mention six basic items with which the auditor should be familiar to understand the computer system used by the client. [Nov, 1996, Question 4(a); 8 marks]

16. What do you understand by 'Audit through the Computer' ?

[May, 1998, Question 7(b); 6 marks]

17. The use of computer facilities by a small enterprise may increase the control risk.

[Nov, 1998, Question 3(a)(ii); 4 marks]

18. (a) State briefly the different types of internal control that you will examine as an auditor in a computer based system. [Nov, 1998, Question 5(a); 3 marks]

(b) Distinguish between

(i) Auditing around the computer; and

(ii) Auditing with the computer. [Nov, 1998, Question 5(b)(i)(ii); 8 marks]

19. "Installation of computer operating systems have created both benefits and problems for auditors." Discuss the statement. [May, 1999, Question 6(a); 6 marks]

20. Explain briefly the approaches to EDP auditing. [Nov, 1999, Question 3(b); 7 marks]

21. (a) Processing of accounting application through computers in no way affects the principles of auditing. [Dec, 1999, Question 6(a); 8 marks]

22. Comment on the following:

The overall objective and scope of an audit does not change in an EDP environment.

[May, 2000, Question 4(a); 6 marks]

23. 'Doing an audit in an EDP environment is simpler since the trial balance always tallies?'

Analyse critically. [Nov, 2000, Question 5(d); 4 marks]

24. What are the different design and procedural aspects of EDP systems?

[Nov, 2001, Question 5(a), 8 marks]

25. Explain the Internal controls in an EDP Environment.

[Nov, 2002, Question 4, 16marks]

26. What are the types of internal control in a computer-based system?

[May, 2003, Question 7(b) 8 marks]

27. Can the Statutory Auditor rely upon the work of an Internal Auditor?

[Nov, 2003, Question 3 (a); 8 marks

28. What do you understand by Audit through the Computer?

[Nov, 2003, Question 3 (b); 8 marks

29. What are the aims of internal control so far as Financial and Accounting aspects are concerned? [Nov, 2003, Question 5(a), 12 marks]

30. What is an Audit Trail? Briefly state the special audit techniques using the computer as an audit tool. [May, 2004, Question 3(b), 8 marks]

31. Explain the important requirements which should be kept in mind to establish or evaluate a system of internal control for application process at Service Bureau.

[May, 2004, Question 4(a), 10 marks]

32. "Installation of Computer Operating System have created both benefits and problems for auditors". Explain the Statement. [May, 2004, Question 7(b), 6 marks]

33. What do you understand by: (i) Auditing and around the computer & (ii) Auditing through the computer. [May, 2005, Question 3 (b)(i) & (ii), 4+4 marks]

34. How will you vouch/verify the following:

    (a) Advertisement expenses

    (b) Goodwill

    (c) Capital work-in-progress

    (d) Wages paid to seasonal labourer

[May, 2005, Question 5 (a), (b), (c) & (d), 4×4=16 marks]

35. Briefly explain the following:

    (i) Control Risk

    (ii) Management Representation [Nov., 2005, Question 2(c) (i)&(ii), 2+2=4 marks]

36. Is there any change in audit approach in the audit of computerised accounts as compared to audit of manual accounts? [Nov., 2005, Question 5(b), 8 marks]

37. Why are Computer Aided Audit Techniques (CAAT) required in EDP audit? What are the advantages of CAATs? [May., 2006, Question 3(a), 10 marks]

38. What are the special steps involved in framing a system of Internal Check?

[May, 2006, Question 6(a) 8 marks]

Short Notes

(a) Review and Testing of the Internal Control System

[May, 1995, Question 8(c); 8 marks]

(b) Examination in Depth [May, 2000, Question 8(b); 4 marks]

(c) Auditing in Depth [Nov, 1995, Question 8(d); 4 marks]

(d) Examination in Depth [Nov, 1997, Question 8(c); 4 marks]

(e) Audit Risk [Nov., 2002, Question 8(a), 4 marks]

(f) Auditing around the Computer [May, 1996, Question 8(d); 4 marks]

(g) Problems faced while shifting from manual to computer based accounting records.

[Nov, 1997, Question 8(b); 4 marks]

(h) Audit Trail [Nov, 2000, Question 8(b); 4 marks]

(i) Audit Risk [Nov, 2002, Question 8(c), 4 marks]

(j) Audit Risk [May, 2004, Question 8(b), 4 marks]

(k) Audit Trail in a computerized accounting environment

[May, 2004, Question 8(d), 4 marks]

(l) Independence of Internal Auditor [May, 2005, Question 8(b), 4 marks]

V. Vouching

1. How would you ensure the accuracy of the following?
   (a) Retirement Gratuity to Employees.
   (b) Discounted Bills Receivable dishonoured.
   (c) Refund of General Insurance Premium paid.
   (d) Investment in the Capital of the Partnership Firm by a Limited Company.

[May, 1995, Question 6(a), (b), (c) and (d); $4 \times 4 = 16$ marks]

2. How would you verify and/or vouch the following?
   (a) Bills Receivable
   (b) Trade Marks and Copyright
   (c) Assets acquired on Hire-Purchase System
   (d) Excise Duty [May, 1996, Question 3(a), (b), (c) and (d); 4 × 4 = 16 marks]
3. A trader is worried that in spite of substantial increase in sales as compared to the earlier year, there is considerable fall in gross profit. After satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants you to ensure that the purchases have been truthfully recorded. In the circumstances, how you would proceed with the assignment?
   [May, 1997, Question 4; 16 marks]
4. How would you verify and vouch the following?
   (a) Remuneration paid to directors.
   (b) Research and development expenditure.
   (c) Discounted bills receivable dishonoured.
   (d) Consignment sale. [May, 1997, Question 5(a), (b), (c) and (d); 4 × 4 = 16 marks]
5. Distinguish between Vouching and Verification [Nov, 1997, Question 5(a); 5 marks]
6. How would you vouch and/or verify the following?
   (a) Cash Sales
   (b) Income-tax Payment
   (c) Assets acquired under Hire-Purchase System
   (d) Borrowings from Bank [Nov, 1997, Question 6(a); (b), (c) and (d); 4 × 4 = 16 marks]
7. How would you vouch and/or verify the following?
   (i) Consignment transactions in the books of consignee
   (ii) Interest and Dividends received
   (iii) Goodwill
   (iv) Contingent Liabilities
   [May, 1998, Question 4(i); (ii), (iii) and (iv); 4 × 4 = 16 marks]
8. How would you vouch and/or verify the following?
   (i) Preliminary expenses

(ii) Sale of assets

(iii) Purchase returns

(iv) Bills payable [Nov, 1998, Question 4(i); (ii), (iii) and (iv); 4 × 4 = 16 marks]

9. How will you, as an auditor, vouch and/or verify the following?

(a) Remuneration paid to Directors

(b) Customs and Excise Duties

(c) Work-in-Progress

(d) Amounts due to Subsidiary Companies

[May, 1999, Question 4(a); (b), (c) and (d); 4 × 4 = 16 marks]

10. State briefly, how would you audit following year and adjustments made by a manufacturing company:

(a) Provision for Outstanding Expenses.

(b) Prepaid Expenses. [May, 1999, Question 5(a); (b); 4+4 = 8 marks]

11. State briefly the audit objectives of the following:

(i) Examination of Bank Reconciliation Statement

(ii) Reconciliation of the aggregate balances of the individual Sales Ledgers with the Sales Ledger Control Account. [Nov, 1999, Question 3(a) (i) & (ii); 3+3 = 6 marks]

12. (a) How will you vouch and/or verify the following?

(a) Advertisement Expenses

(b) Refund of General Insurance Premium Paid

(c) Empties or Containers

(d) Inventories [Nov, 1999, Question 6(a); (b), (c) and (d); 4 × 4 = 16 marks]

(b) How will you vouch and/or verify the following?

(a) Bankruptcy Dividends

(b) Sale of Investments

(c) Provisions for Freight Charges

(d) Loans on Mortgage of Property

[Dec, 1999, Question 4(a); (b), (c) and (d); 4 × 4 = 16 marks]

(c) How will you vouch and/or verify the following?

(a) Research and Development expenses

(b) Recovery of Bad Debts written off

(c) Goods sent out on Sale or Return Basis

(d) Borrowing from Banks

[May, 2000, Question 6(a); (b), (c) and (d); 4 × 4 = 16 marks]

(d) How will you vouch and/or verify the following?

(a) Goods sent on consignment

(b) Foreign travel expenses

(c) Receipt of capital subsidy

(d) Provision for income tax

[Nov, 2000, Question 3(a); (b), (c) and (d); 4 × 4 = 16 marks]

13. Give your comments and observations on the following:

No entry is passed for cheques received by the auditee on the last day of the year, but not yet deposited with the bank. [Nov, 2000, Question 2 (c); 4 marks]

14. 'In vouching payments, the auditor does not merely check proof that money has been paid away.' Discuss. [Nov, 2000, Question 4 (b); 6 marks]

15. How will you, as an auditor, vouch and/or verify the following:

(i) Deferred Revenue Expenditure

(ii) Goodwill [May, 2001, Question 6(b) (I) & (ii), 4+4 marks]

16. How will you vouch and/or verify the following?

(a) Sale proceeds of Scrap Material.

(b) Trade Marks and Copyrights.

(c) Machinery acquired under Hire-purchase system.

(d) Work-in-progress. [Nov, 2001, 4(a), (b), (c), & (d), 4×4 marks]

17. State briefly how you will verify the following:

(a) Building

(b) Bank Balances

(c) Bills Payable

(d) Borrowing from Banks [May, 2002, Question 5(a), (b), (c) & (d), 18 marks]

18. How will you vouch the following?
    (i) Insurance Claim
    (ii) Travelling Expenses
    (iii) Customs and Excise Duty
    (iv) Shares issued for consideration other than cash [May, 2002, Question 4, 16 marks]
19. How will you vouch and/or verify the following?
    (a) Personal expenses of directors met by the company.
    (b) Preliminary expenses.
    (c) Patents.
    (d) Advances given to suppliers.
    [Nov, 2004, Question 5(a), (b), (c) & (d) 4×4=16 marks]
20. How will you verify/vouch the following?
    (a) Sales Commission Expenditure
    (b) Stock lying with Third Party
    (c) Purchase of Motor Car
    (d) Sales Return [Nov, 2005, Question 5(a), (b), (c) & (d), 4×4=16 marks]
21. State the different types of Analytical Review carried out in verification of inventories.
    [May., 2006, Question 3(b), 6 marks]
22. How will you verify/vouch the following?
    (a) Purchase of quoted investment
    (b) Discounted bill receivable dishonoured
    (c) Amount due to subsidiary companies
    (d) Purchase return [May., 2006, Question 4(a), (b), (c) & (d), 4×4=16 marks]

Short Notes

(a) Outstanding Assets [May, 1997, Question 8(a); 4 marks]
(b) Hire Purchase Sales [Dec, 1999, Question 8(a); 4 marks]
(c) Self and Sectional Balancing Ledgers [Dec, 1999, Question 8(d); 4 marks]
(d) Vouching [Nov., 2005, Question 8(d), 4 marks]

VI. Verification of Assets and Liabilities

1. Distinguish between:
   (a) Vouching and Verification [May, 1995, Question 3(a); 6 marks]
   (b) Depreciation and Fluctuation in Value [May, 1995, Question 3(b); 5 marks]
   (c) Distinguish between Capital Expenditure and Revenue Expenditure.
   [May, 1995, Question 5(c); 6 marks]

2. How would you verify the following items in the books of account of a company which you are auditing?
   (a) Goodwill
   (b) Amounts due to, a subsidiary company
   (c) Loans given against the security of Land
   (d) Loans given against the security of Goods
   [Nov, 1995, Question 4(a), (b), (c) and (d); $4 \times 4 = 16$ marks]

3. (a) "Physical presence of the auditor at the time of year end verification of stock is though not always possible, it is recommended that he should at least be present as an observer."
   Signify the importance of this statement and list out the important aspects which the auditor should look into to ensure an effective physical verification programme.
   [May, 1996, Question 1(a); 12 marks]

4. How would verify and/or vouch the following?
   (a) Bills Receivable
   (b) Trade Marks and Copyright
   (c) Assets acquired on Hire-Purchase System
   (d) Excise Duty [May, 1996, Question 3(a), (b), (c) and (d); $4 \times 4 = 16$ marks]

5. (a) Distinguish between Capital and Revenue Expenditure.
   [May, 1996,Question 6(a); 4 marks]
   (b) State with reasons your opinion in regard to treatment of the following transactions appearing in your clients books of accounts:
   (1) Substantial Expenditure incurred for the repair of a machinery.

(2) Expenditure incurred to remove "Overburden" for purposes of facilitating mining activities.

(3) Advertisement Campaign Expenditure incurred to introduce a new product in the market.

(4) Training Expenses incurred by the company for technical personnel before commencement of commercial production by a new company.

[May, 1996, Question 6(b); 3 × 4 = 12 marks]

6. How would you verify the following?

(i) Works-in-progress [Nov, 1996, Question 4(b)(i); 4 marks]

(ii) Outstanding liabilities for expenses [Nov, 1996, Question 4(b)(ii); 4 marks]

7. You have been appointed auditor of XYZ Ltd. The management committee has requested you to:

(a) Distinguish for them the following:

(i) General reserve and Specific reserve [Nov, 1996, Question 6(a)(i); 5 marks]

(ii) Capital reserve and Reserve capital [Nov, 1996, Question 6(a)(ii); 5 marks]

(b) State whether it would be possible to keep "Secret Reserve" any longer secret.

[Nov, 1996, Question 6(b); 6 marks]

10. How would you verify and vouch the following?

(a) Remuneration paid to directors.

(b) Research and development expenditure.

(c) Discounted bills receivable dishonoured.

(d) Consignment sale. [May, 1997, Question 5(a), (b), (c) and (d); 4 × 4 = 16 marks]

11. Distinguish between Vouching and Verification [Nov, 1997, Question 5(a); 5 marks]

12. Distinguish between Capital Expenditure and Revenue Expenditure.

[Nov, 1997, Question 5(c); 6 marks]

13. How would you vouch and/or verify the following?

(a) Cash Sales

(b) Income-tax Payment

(c) Assets acquired under Hire-Purchase System

(d) Borrowings from Bank [Nov, 1997, Question 6(a); (b), (c) and (d); 4 × 4 = 16 marks]

14. What is Depreciation of Fixed Assets and why is it provided? Can a company change the method of providing depreciation? [May, 1998, Question 1(b); 5 marks]

15. How would you vouch and/or verify the following?

    (i) Consignment transactions in the books of consignee

    (ii) Interest and Dividends received

    (iii) Goodwill

    (iv) Contingent Liabilities [May, 1998, Question 4(a); (b), (c) and (d); 4 × 4 = 16 marks]

16. What are the general considerations for valuation and verification of assets?

    [May, 1998, Question 7(a); 10 marks]

17. As an auditor, how would you react to the following situation:

    Included under sundry creditors was fees payable to the legal counsel for suits filed against the company. The company is not aware of the status of the suits and hence did not want to provide for the same. [Nov, 1998, Question 1(c); 4 marks]

18. State the reasons, how the following items should be allocated to capital and revenue:

    (i) Repairs to building done shortly after purchase.

    (ii) Costs of raising a loan [Nov, 1998, Question 3(b); 4+4 = 8 marks]

19. How would you vouch and/or verify the following?

    (i) Preliminary expenses

    (ii) Sale of assets

    (iii) Purchase returns

    (iv) Bills payable [Nov, 1998, Question 4(i); (ii), (iii) and (iv); 4 × 4 = 16 marks]

20. State your views on the following:

    (a) Events occurring after the Balance Sheet date [Nov, 1998, Question 7(a); 8 marks]

    (b) Verification, valuation and disclosure of fixed assets.

    [Nov, 1998, Question 7(b); 8 marks]

21. As an auditor, comment on the following situations/statements:

    (a) The sale and purchase of Investments of Z Ltd. was controlled through a committee. Mr S sold some of the investments without discussing the same with the other members of the committee as they were out of station and Mr S believed

that its price would fall and the company would suffer a loss if it is not sold. Z Ltd. earned a profit of Rs.1 lakh from such sale. [May, 1999, Question 2(a); 5 marks]

(b) Z Ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue Expenditure. The product did not pick up and the sales were negligible. [May, 1999, Question 2(b); 4 marks]

(c) The sale proceeds from scrap which did not have a significant value need not be verified if the company had a good accounting and costing system.

[May, 1999, Question 2 (d); 4 marks]

22. Your firm has been appointed as auditor of ABC Ltd. State your opinion on the following matter:

"The management requested your firm not to comment on valuation of Inventory and realisability of certain debtors, as they had been covered in the Directors' Report.

[May, 1999, Question 3 (d); 4 marks]

23. How will you, as an auditor, vouch and/or verify the following?

(a) Remuneration paid to Directors

(b) Customs and Excise Duties

(c) Work-in-Progress

(d) Amounts due to Subsidiary Companies

[May, 1999, Question 4(a); (b), (c) and (d); $4 \times 4 = 16$ marks]

24. State briefly, how would you audit following year and adjustments made by a manufacturing company:

(a) Provision for Depreciation [May, 1999, Question 5(c); 4 marks]

(b) Proposed Dividends [May, 1999, Question 5(d); 4 marks]

25. How will you vouch and/or verify the following?

(a) Advertisement Expenses

(b) Refund of General Insurance Premium Paid

(c) Empties or Containers

(d) Inventories [Nov, 1999, Question 6(a); (b), (c) and (d); $4 \times 4 = 16$ marks]

26. How will you vouch and/or verify the following?

(a) Bankruptcy Dividends

(b) Sale of Investments

(c) Provisions for Freight Charges

(d) Loans on Mortgage of Property

[Dec, 1999, Question 4(a); (b), (c) and (d); 4 × 4 = 16 marks]

27. State your opinion/comment on the following:

(a) The Cash-book showed a huge Cash Balance on hand consistently throughout the year. [May, 2000, Question 2(d); 4 marks]

(b) The responsibility for properly determining the quantity and value of inventories rests with the management of the entity. [May, 2000, Question 4(c); 4 marks]

28. How will you vouch and/or verify the following?

(a) Research and Development expenses

(b) Recovery of Bad Debts written off

(c) Goods sent out on Sale or Return Basis

(d) Borrowing from Banks [May, 2000, Question 6(a); (b), (c) and (d); 4 × 4 = 16 marks]

29. As an auditor, what would you do in the following situations:

(a) The method of depreciation on plant and machinery is to be changed from SLM basis to WDV basis from the current year. [Nov, 2000, Question 1(a); 4 marks]

(b) The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year. [Nov, 2000, Question 1(d); 4 marks]

30. Give your comments and observations on the following:

(a) Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the year-end. [Nov, 2000, Question 2(a); 4 marks]

(b) The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees. [Nov, 2000, Question 2(b); 5 marks]

(c) Fixed assets have been revalued and the resulting surplus has been adjusted against the brought forward losses. [Nov, 2000, Question 2(d); 5 marks]

31. How will you vouch and/or verify the following?

(a) Goods sent on consignment

(b) Foreign travel expenses

(c) Receipt of capital subsidy

(d) Provision for income tax

[Nov, 2000, Question 3(a); (b), (c) and (d); 4 × 4 = 16 marks]

32. State briefly the duty of an auditor with regard to each of the following:

(a) No depreciation has been charged for the year ended 31st March, 2001, in respect of a spare Bus purchased during the year and kept ready by the company for use as a stand-by on the ground that it was not used during the year.

[May, 2001, Question 1 (a), 5 marks]

(b) A sum of Rs.10,00,000 is received from an Insurance company in respect of a claim for loss of goods in transit costing Rs.8,00,000. The amount is credited to the Purchases Account. [May, 2001, Question 1 (b), 5 marks]

(c) Cost of structural alterations amounting to Rs.60,000 to self-owned factory premises has been charged to Building Repairs. [May, 2001, Question 1 (c), 4 marks]

(d) A loss of Rs.2,00,000 on account of embezzlement of cash was suffered by the company and it was debited to Salary Account.

[May, 2001, Question 1 (d), 4 marks]

33. Explain the difference between Depreciation and Fluctuation in Value.

[May, 2001, Question 4 (a), 6 marks]

34. State how you would verify the following:

(i) Buildings

(ii) Patent Rights [May, 2001, Question 6(a) (I) & (ii), 4+4 marks]

35. (a) Explain the meaning of the term "subsequent events" as used in the statement on Standard Auditing Practices (SAP) 19. [Nov, 2001, Question 3(a), 3 marks]

(b) Should all type of subsequent events be considered by the auditor in his attest function? [Nov, 2001, Question 3(b), 3 marks]

(c) Indicate briefly the procedures to identify subsequent events requiring adjustment of or disclosure in the financial statements. [Nov, 2001, Question 3(c), 10 marks]

36. As an auditor, comment on the following situations/statements:

(a) A Ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue expenditure. The product did not pick up and the sales were negligible. It is anticipated that no material benefit will accrue in future from such heavy advertisement expenditure.

(b) B Ltd. acquired a car for its Managing Director on hire-purchase basis. The interest payable as well as penalty for late payment of instalments was added to the cost of the car.

(c) The debit balance in the profit and loss account is shown as a deduction from Investment Allowance Reserve on the liabilities side of the Balance Sheet.

(d) Assets purchased under hire-purchase system were reflected at their full value and the outstanding instalments payable have been included under Sundry Creditors.

[May, 2002, Question 2(a), (b), (c) & (d); 18 marks]

37. What would be your comments, as an auditor on the following?

(a) In the looks of Lacklustre Ltd. surplus arising on revaluation of Plant and Machinery has been credited to the Profit and Loss Account to the extent depreciation charged thereon in the earlier years.

(b) Directors of MN Ltd. has shown in its Balance Sheet the amount of interest accrued and due on Unsecured Loan under the head 'Current Liabilities and Provisions' on the ground that such interest has to be paid within three months.

(c) S Ltd. purchased a Bus on Hire-purchase system from AR Leasing and Finance Co. It debited the assets account with full value and outstanding amount have been shown as liability.

(d) Raw material stocks imported and remaining to be cleared from customs, not considered for inclusion in the annual inventory.

[Nov., 2002, Question 1(a), (b), (c) & (d); 18 marks]

38. Discuss the accounting principles having relevance to the auditor relating to:

(i) Prior Period Items, and

(ii) Extraordinary Items [Nov., 2002, Question 5(a) 8 marks]

39. How will you vouch and/or verify the following:

(a) "Retirement Gratuity to Employees.

(b) Sale Proceeds of Junk Materials

(c) Assets Abroad

(d) Patent Rights [Nov., 2002, Question 5(a), (b), (c) & (d), 4 marks each]

40. List the aspects to be considered in vouching/verification of the following:

(a) Research and Development Expenditure

(b) Discounted bills receivable dishonoured

(c) Borrowing from banks

(d) Plant and Machinery [May, 2003, Question 4(a), (b), (c) & (d) 4 marks each]

41. How will you vouch and/or verify the following?

(a) Remuneration to directors.

(b) Consignment sales.

(c) Patent rights.

(d) Royalties received. [Nov, 2003, Question 4(a), (b), (c) & (d) 4 marks each]

42. What are accounting estimates according to Auditing and Assurance Standard (AAS) 18? Give examples. [Nov, 2004, Question 4(b) 8 marks]

43. While conducting the audit of the accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply risen in comparison to the previous year. State the steps you would take to satisfy yourself.

[Nov, 2004, Question 7(a) 12 marks]

Short Notes

(a) Floating Charge [May, 1995, Question 8(b); 4 marks]

(b) Deferred Revenue Expenditure [Nov, 1995, Question 8(c); 4 marks]

(c) Cut-off Procedure [Nov, 1997, Question 8(a); 4 marks]

(d) Intangible assets [Nov, 1998, Question 8(a); 4 marks]

(e) Floating charge [Nov, 1998, Question 8(c); 4 marks]

(f) Goods in Bond [Dec, 1999, Question 8(b); 4 marks]

(g) Contingent Liability [Nov, 2001, Question 8(a), 4 marks]

(h) Cut-off Transactions relating to Inventories [May, 2002, Question 8(a), 4 marks]

(i) Outstanding Assets [Nov., 2002, Question 8(d), 4 marks]

(k) Cut-off arrangement [May, 2003, Question 8(b), 4 marks]

(l) Outstanding Assets [Nov, 2003, Question 8(a), 4 marks]

(m) Extent of Reliance on Analytical Procedures [Nov, 2003, Question 8(c), 4 marks]

(n) Purpose of providing depreciation [Nov, 2003, Question 8(d), 4 marks]

(o) Intangible Assets [May, 2004, Question 8(a), 4 marks]

(p) Floating Charge [May, 2004, Question 8(d), 4 marks]

(q) Disclosure requirements of bank balances of a limited company

[Nov, 2004, Question 8(c), 4 marks]

(r) Surprise Check [May, 2005, Question 8(a), 4 marks]

(s) Going Concern Concept [Nov., 2005, Question 8(c), 4 marks]

(t) Scrutiny of General Ledger [May, 2006, Question 8(b), 4 marks]

(u) General Principles of Verification of Assets [May, 2006, Question 8(d), 4 marks]

VII. The Company Audit-I

1. (a) In each of the following cases; is the auditor's appointment valid ?

   (i) At the annual general meeting of Navkar Ltd., Om is appointed as the auditor. Om refuses to accept the audit. The company holds another general meeting and appoints a new auditor.

   (ii) Due to the resignation of the existing auditor, the board of directors of Hanuman Ltd. appoint Ram as the auditor.

   (iii) Paras is appointed the auditor of a government company at its annual general meeting. [May, 1995, Question 2(a)(i), (ii) & (iii); 3+3+3 = 9 marks]

   (b) Comment and give your views on the following:

   (i) While conducting the audit of a company for the year ended 31st March, 1993, the auditor called for the General Ledger for the year ended 31st March, 1990, for some reference. He could not get that ledger as the books of accounts of that year were already destroyed as per the instructions of the Executive Director of the Company. [May, 1995, Question 2(b)(i); 4 marks]

   (ii) A public limited company has issued Debentures which are guaranteed by the Government of India both as to the repayment of the principal and interest but not secured by any charge on the assets of the company and disclosed the same as 'Secured Loans' in the Balance Sheet.

   [May, 1995, Question 2(b)(ii); 5 marks]

2. You have been appointed the sole auditor of a company where you were one of the joint auditors for the immediately preceding year and the said joint auditor is not reappointed.

   State the various steps you would take for ascertaining the compliance of the requirements of the Companies Act before accepting the audit.

   [Nov, 1995, Question 2(a); 10 marks]

3. What are the powers of the auditor of a company? [May, 1996, Question 2(b); 6 marks]

4. Under what circumstances the retiring auditor of a company cannot be reappointed.

[May, 1996, Question 2(c); 6 marks]

5. Can a company restrict the rights of its Statutory Auditor?

[Nov, 1996, Question 3(a); 4 marks]

6. Mention the items to be considered by the auditor of a limited company under Section 227(1A) of the Companies Act. [Nov, 1996, Question 3(b); 12 marks]

7. As an auditor, how would react to the following situations?

   (a) The Board of Directors have appointed you as auditor of the company consequent to the resignation of the auditor Shri Kulkarni [May, 1997, Question 2(a); 4 marks]

   (b) A Ltd. requiring to make and maintain cost accounts and records contends that the auditor need not report on the non-maintenance of cost records because the provisions of cost audit were not made applicable to it.

[May, 1997, Question 2(b); 4 marks]

8. Briefly discuss the persons who are disqualified for being appointed as auditor of a company.

[Nov, 1997, Question 2(a); 9 marks]

9. State with reasons your views on the following:

   (i) The auditor of Y Ltd. resigned after valid and accepted appointment whereupon the Board of Directors appointed another auditor treating it as a casual vacancy.

   (ii) The Board of Directors of Z Ltd., whose 25% subscribed share capital is held by State Government, proposes to appoint Mr. K, a Chartered Accountant, as its statutory auditor in the next Annual General Meeting.

   (iii) A limited company passed a resolution by entire body of shareholders limiting the powers of its Statutory Auditor. [Nov, 1997, Question 2(b); 3+3+3 = 9 marks]

10. What are the powers of the auditor of a company? [May, 1998, Question 2(a); 6 marks]

11. Due to the resignation of the existing auditor, the Board of Directors of X Ltd. appointed Mr. Hari as the auditor. Is the appointment of Hari as auditor valid?

[May, 1998, Question 2(b); 6 marks]

12. What is your reaction, as an auditor, in the following circumstances:

    X Ltd. was incorporated on 1.2.1998 and Mr P who is related to the Chairman of the company was appointed as auditor by the Board of Directors in their meeting on 3.3.1998. [May, 1998, Question 2(c); 6 marks]

13. Explain the different types of Audit Reports. [May, 1998, Question 3(a); 8 marks]

14. State your opinion on the following matters:

    (i) XYZ & Company Limited wants to remove their existing auditors before the expiry of their term. [Nov, 1998, Question 2(b)(i); 4 marks]

    (ii) XYZ & Company Limited by passing a resolution by the entire body of shareholders wants to limit the powers of the statutory auditors.

    [Nov, 1998, Question 2(b)(ii); 4 marks]

    (iii) The auditors lien on client's books and records is unconditional.

    [Nov, 1998, Question 2(b)(iii); 2 marks]

15. State with reasons your views on the following:

    (a) Mr X, a partner of X & Co., Chartered Accountants died of a heart attack on 30.3.99 after completing the entire routine audit work of T Ltd., Mr Y one of the partners of the firm, therefore signed the accounts of T Ltd. without reviewing the finalisation work done by the assistants. [May, 1999, Question 1(a); 4 marks]

    (b) A senior assistant of X & Co. Chartered Accountants drew up his audit programme without evaluating internal controls of T Ltd. When the partner asked firm for the reason, he stated that the controls were developed by the General Manager (Finance) of T Ltd., who is a Chartered Accountant and had written a few books on "Internal Control" and, therefore there was no need to review the said area.

    [May, 1999, Question 1(b); 5 marks]

    (c) An assistant of X & Co., Chartered Accountants detected an error of Rs.5 per interest payment which recurred number of times. The General Manager (Finance) of T Ltd. advised him not to request for passing any adjustment entry as individually the errors were of small amounts. The company had 2,000 Deposit Accounts and interest was paid quarterly. [May, 1999, Question 1(c); 5 marks]

    (d) An assistant of X & Co., Chartered Accountants wanted to verify the cash in hand and investments of T Ltd. The General Manager (Finance) of T Ltd. suggested to the assistant of X & Co. that it was not necessary as his staff had done the same only few days back and no discrepancies were notified.

    [May, 1999, Question 1(d); 4 marks]

16. Your firm has been appointed as auditor of ABC Ltd. State your opinion on the following matter:

    The company had also appointed a Cost Auditor and therefore, the management had requested your firm not to review the cost records.

    [May, 1999, Question 3(c); 4 marks]

17. Comment on the following:

    (i) In case the existing auditors appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy?

    (ii) X and Co., Chartered Accountants, who were appointed as the first auditors of the company, were removed without the prior approval of the Central Government, before the expiry of their term, by calling an Extra-ordinary General Meeting.

    (iii) At the Annual General Meeting of a company in which a nationalised bank held 20% of the subscribed capital, X and Co., Chartered Accountants, were appointed as auditors by passing an ordinary resolution.

    [Nov, 1999, Question 1(i), (ii) & (iii); 3+3+3 = 9 marks]

18. "Auditor's report implies an expression of opinion by the auditor." Discuss the statement.

    [Nov, 1999, Question 4(a); 10 marks]

19. Explain what is meant by:

    (i) Qualified Report

    (ii) Adverse or Negative Report

    (iii) Disclaimer of Opinion [Nov, 1999, Question 4(b)(i), (ii) & (iii); 2+2+2 = 6 marks]

20. Comment on the following:

    (a) Hanuman, a Chartered Accountant, is a relative of Ram who is having a substantial interest in Navkar Ltd. Hanuman expresses opinion on financial statements of the company. [Dec, 1999, Question 1(a); 5 marks]

    (b) No auditor was appointed in the annual general meeting of Shanti Ltd.

    [Dec, 1999, Question 1(b); 4 marks]

    (c) The auditor of Om Ltd. did not report on the matters specified in Sub-section (IA) of Section 227 of the Indian Companies Act, 1956 as he was satisfied that no comment is required. [Dec, 1999, Question 1(c); 5 marks]

21. Comment on the following:

(a) NM & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Various co-operative and term lending institutions held 51% of the paid up share capital of the company.

(b) Mr L, a chartered accountant in full-time practice, was acting as the statutory auditor of a public limited company, till it was wound up. Mr L was appointed as the liquidator for purposes of winding up proceedings.

[May, 2000, Question 1(a) & (b); 4+4 = 8 marks]

(c) In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.

(d) X and Co., Chartered Accountants, who were appointed as the first auditors of the company, were removed without the prior approval of the Central Government, before the expiry of their term, by calling an Extraordinary General Meeting.

(e) Due to the resignation of the existing auditor(s), the Board of directors of X Ltd. appointed Mr. Hari as the auditor. Is the appointment of Hari as auditor valid?

(f) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted ?

[May, 2002, Question 1(a),(b), (c) & (d); 18 marks]

22. As an auditor comment on the following situation:

(a) A company had a branch office, which recorded a turnover of Rs.1,99,000 in the earlier year. The auditors report of the earlier year had no reference regarding the branch, although, the branch audit had not been carried out by the Statutory Auditor. [May, 2000, Question 3(c); 4 marks]

23. State your opinion/comment on the following:

(a) An auditor purchased goods worth Rs.1,500 on credit from a company being audited by him. The company allowed him one month's credit, which it normally allowed to all known customers.

(b) An auditor became aware of a matter regarding a company, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion.

[May, 2000, Question 5(a) & (b); 4+4 = 8 marks]

24. 'At the AGM of ICI Ltd., Mr X was appointed as the statutory auditor. He, however, resigned after 3 months since he wanted to give up practice and join industry.

    State, how the new auditor will be appointed by ICI Ltd.

    [Nov, 2000, Question 5(a); 4 marks]

25. Give your comments and observations on the following:

    (i) KBC & Co. a firm of Chartered Accountants has three partners, K, B & C; K is also in whole time employment elsewhere. The firm is offered the audit of ABC Ltd. and its twenty branches. The firm already holds audit of 40 companies including audit of one foreign company. [May, 2001, Question 2(i); 5 marks]

    (ii) At the Annual General Meeting of CU Ltd., Mr. L is appointed as the auditor which later is held to be void ab initio. The company holds another general meeting and appoints a new auditor. [May, 2001, Question 2(ii); 4 marks]

    (iii) At an Annual General Meeting, Mr. R a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P, could not be proceeded with, due to Mr. P's death.

    [May, 2001, Question 2(iii); 4 marks]

    (iv) MNC Ltd. in which 24 per cent of the subscribed capital is held by a public financial institution at the time of issuing the notice for the Annual General Meeting, appoints RK & Co. as auditors by an ordinary resolution at the Annual General Meeting when the Public Financial Institution increased its Stake in MNC Ltd. to 25 per cent of its subscribed capital. [May, 2001, Question 2(iv); 5 marks]

26. Explain the difference between Clean Audit Report and Qualified Audit Report.

    [May, 2001, Question 4(b), 5 marks]

27. What will be position of the Auditor in the following cases?

    (a) A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September, 2000, which assignment he accepted. Subsequently in January, 2001 he joined B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.

    [Nov, 2001, Question 2(a), 5 marks]

    (b) K, a chartered accountant, was appointed as auditor of Y Ltd. In the 12th Annual General Meeting of the company in September, 1999. In June, 2000 the company removed him through a resolution in the general meeting and appointed Ram as its auditor. [Nov, 2001, Question 2(b), 5 marks]

(c) Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors. [Nov, 2001, Question 2(c), 4 marks]

(d) While conducting the audit of a limited company for the year ended 31st March, 2000, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

[Nov, 2001, Question 2(d), 4 marks]

28. (a) How would you as an auditor distinguish between Reports and Certificates?

(b) State the circumstances when qualified Audit Report is obligatory.

[May, 2002, Question 4(a) & (b), 18 marks]

29. (a) A Ltd. wants to remove their existing auditor, appointed in the 5th AGM, before the expiry of his term. What shall be the procedure for his removal?

(b) What is your reaction, as an auditor, in the following circumstances?

A Ltd. was incorporated on 3rd February, 2002 and Hari, who is a partner of an officer of the company, was appointed as first auditor by the Board of Directors in their meeting held on 1st March, 2002.

(c) At the AGM of a company, in which a Nationalised Bank held 30% of the subscribed capital. Hari & Co., Chartered Accountants, were appointed as auditor by passing an ordinary resolution. Comment.

(d) Ram, the statutory auditor of B. Ltd., wanted to visit the Branch Office of the company, whose accounts have been audited by some other Chartered Accountant. The M.D. of the company refused him to allow the visit and access of the accounts and vouchers of that branch on the plea that the accounts have been audited by a Chartered Accountant and his report is available to him. Comment.

[Nov., 2002, Question 2(a), (b), (c) & (d), 18 marks]

30. What is Special Audit and under what circumstances such an audit may be required?

[Nov., 2002, Question 3(a) 8 marks]

31. State with reasons your views on the following:

(a) Ram and Hanuman Associates, Chartered Accountants in practice have been appointed as Statutory Auditor of Krishna Ltd. For the accounting year 2002-2003. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd. [Nov., 2002, Question 1(c) 5 marks]

(b) Mr. Rajendra, a fellow member of the Institute of Chartered Accountants of India, working as Manager of Shrivastav and Co., a Chartered Accountant firm, signed the audit report of Om Ltd. On behalf of Shrivastav & Co.

[Nov., 2002, Question 1(d) 5 marks]

32. As an auditor, comment on the following situations/statements:

(a) The first auditors of Health and Wealth Ltd., a Government company, was appointed by the Board of Directors.

(b) In case the existing auditors reappointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy?

(c) The auditor of Trilok Ltd. did not report on the matters specified in sub-section (1A) of Section 227 of the Companies Act, 1956, as he was satisfied that no comment is required.

(d) At the AGM of a company, in which a Nationalised Bank held 25% of the subscribed capital, Krishna & Co., Chartered Accountants, were appointed as auditor by passing an ordinary resolution.

(e) The members of C. Ltd. preferred a complaint against the auditor stating that he has failed to send the auditors report to them.

(f) One of the directors of Hitech Ltd. is attracted by the disqualification under Section 274(1)(g). [Nov., 2003, Question 1(a), (b), (c) & (d) 3 marks each]

33. Give your comments on the following:

(a) PQR & Co. a firm of Chartered Accountants has three partners, P, Q and R; P is also in whole time employment elsewhere. The firm is already holding audit of 40 companies including audit of one foreign company. The firm is offered the audit of Z Ltd. and its 20 branches. (5 marks)

(b) It is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems.

(4 marks)

(c) Nene and Sane Associates, Chartered Accountants in practice have been appointed as statutory auditor of Do Good Ltd. for the accounting year 2003-04. Mr. Nene holds 200 equity shares of DDA Ltd. a subsidiary company of Do Good Ltd.

(5 marks)

(d) White Star Ltd. was incorporated on 1.8.2003 and Mr. T who is related to the Chairman of the Company appointed as auditor by the Board of Directors in their meeting on 4.9.2003. (4 marks)

[May, 2004, Question 2(a), (b), (c) & (d)]

34. (a) The auditor of a limited company has given a clean report on the financial statement on the basis of Xerox copies of the books of accounts, Vouchers and other records which were taken away by the Income-tax Department in search under section 132 of the I.T. Act, 1961. (5 marks)

(b) E and S were appointed as Joint Auditors of X and Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors. (5 marks)

(c) Aakansha is a member of the Institute of Chartered Accountants of England and Wales. Is she qualified to be appointed as auditor of Indian Companies? (2 marks)

(d) Preksha, a member of the ICAI, does not hold a Certificate of practice. Is her appointment as an auditor valid? (4 marks)

(e) 'B' owes Rs. 1001 to 'C' Ltd., of which he is an auditor. Is his appointment valid? Will it make any difference, if the advance is taken for meeting-out travelling expenses? (4 marks)

[Nov, 2004, Question 2(a), (b), (c), (d) & (e)]

35. Give your comments on the following:

(i) The Central Government has appointed Mr. Sushil, a retired Finance Director of a reputed company, a non-practising member of ICAI, as a special auditor of MM Ltd., on the ground that the company was not being managed on sound business principles. Mr. Ajay, MD of MM Ltd. feels, that the appointment of Mr. Sushil is not valid as he does not hold a certificate of practice.

(ii) CC Ltd., a Pharmaceutical Company, while valuing its finished stock at the year end wants to include interest on Bank Overdraft as an element of cost, for the reason that overdraft has been taken specifically for the purpose of financing current assets like inventory and for meeting day to day working expenses.

[May, 2005, Question 2(a)(i)&(ii), 5+5 marks]

36. As an auditor, comment on the following:

(a) M/s Bonafide Ltd. Has taken a Group Gratuity Policy from an Insurance Company. During accounting year 2004-05 it received a communication from the said Insurance Company informing that premium amount for the accounting year 2003-04 was less charged by Rs.75 lacs on account of arithmetical error on the part of Insurance Company. M/s Bonafide Ltd. Paid the said sum of Rs. 75 lacs during the accounting year 2004-05 by debiting the same to Prior Period Expenses.

(b) As on 31.3.2005, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide satisfactory after-sales services in relation to the software purchased from it. Before finalisation of the accounts for the year ended 31.3.2005 (the accounts were finalised on 14th June, 2005), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 31.3.2005, which, it says, will be reversed in the next year.

(c) Mr. A was appointed auditor of AAS Ltd. By Board to fill the casual vacancy that arose due to death of the auditor originally appointed in AGM. Subsequently, Mr. A also resigned on health grounds during the tenure of appointment. The Board filled this vacancy by appointing you through duly passed Board resolution.

(d) SK Ltd. Has fully computerised its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories at the year end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.

[Nov., 2005, Question 1(a), (b), (c) & (d) 5+5+4+4=18 marks]

37. (a) Give your comments on the following:

(i) The auditors of ABC Ltd. Issued a qualified opinion about the truth and fairness of the accounts of the company for the year ended 31.3.2005. They typed out the matters of qualifications in a bold font so as to invite the attention of the readers to them. The Board objected to it and required them to be typed out in the same normal font as other paragraphs of the report appear.

(ii) Auditors of M/s Fortune India (P) Ltd. Were changed for the accounting year 2004-05. The closing stock of the company as on 31.3.2004 amounting to Rs. 100 lacs continued as it is and became closing stock as on 31.3.2005. The auditors of the company propose to exclude from their audit programme the audit of closing stock of Rs. 100 lacs on the understanding that it pertains to the preceding year which was audited by another auditor.

[Nov., 2005, Question 2(a) & (b) 5+5=10 marks]

38. (a) State the matters to be specified in Auditor's Report in terms of provisions of Section 227(3) of the Companies Act, 1956.

(b) What are the reporting requirements in Companies (Auditor's Report) Order, 2003 in respect of money raised by public issues?

[Nov., 2005, Question 7(a) & (b) 8+8=16 marks]

39. As an auditor, comment on the following situations/statements:

(a) Travelling expenses of Rs. 2.25 lakhs shown in Profit and Loss Account of X Ltd., including a sum of Rs. 1.10 lakhs spent by a Director on his foreign travel for company's business accompanied by his mother for her medical treatment

(b) X Ltd., to whom Companies (Auditor's Report) Order, 2003 is applicable, has issued 9% Debenture of Rs. 5 crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry Creditors and other Current Liabilities of Rs. 2.80 crores.

(c) The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately.

(d) The register of members of AP Ltd. Has not been written up-to-date and as a result, the balances in the register do not agree with the amount of issued Share Capital.

[May, 2005, Question 1(a), (b), (c) & (d) 4×5=20 marks]

40. Give your comments on the following:

(a) Mr. X, a Director of M/s KP Private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filed the annual accounts and annual return for last three years 2002-03 to 2004-05. Mr. X is of the opinion that he is not disqualified u/s 274(1)(g) of the Companies Act, 1956, and auditor should not mention disqualification remark in his audit report.

(b) Mr. Aditya, a practicing chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Singhvi is the Managing Director.

(c) You have been appointed the sole auditor of a company where you were one of the joint auditors for the immediately preceding year and the said joint auditors is not re-appointed.

(d) No Annual General Meeting (AGM) was held for the year ended 31st March, 2005, in XYZ Ltd., Ninu is the auditor for the previous year, whether she is continuing to hold office for current year or not.

[May, 2006, Question 2(a), (b), (c) & (d) 5+4+4+3=16 marks]

41. State the different types of Analytical Review carried out in verification of inventories.

[May, 2006, Question 3 (b) 6 marks]

42. What are the special considerations in an audit of a Limited Company?

[May, 2006, Question 5 (a) 8 marks]

Short Notes

(a) Qualified Audit Report [May, 1996, Question 8(b); 4 marks]

(b) Appointment of auditor by the Central Government in case the auditor is not appointed in the AGM. [Nov, 1997, Question 8(d); 4 marks]

(c) Disclaimer of Opinion [May, 1999, Question 8(d); 4 marks]

(d) Auditor's Lien [Nov, 2000, Question 8(a); 4 marks]

(e) Disclaimer of Opinion [Nov, 2000, Question 8(c); 4 marks]

(f) Clean Audit Report [May, 2002, Question 8(c), 4 marks]

(g) Buy Back of Own Securities [Nov, 2002, Question 8(a), 4 marks]

(h) Disclaimer of Opinion [May, 2003, Question 8(a), 4 marks]

(i) Cost Audit [May, 2005, Question 8(c), 4 marks]

(j) Capital Redemption Reserve [May, 2005, Question 8(d), 4 marks]

VIII. The Company Audit-II

1. What are the provisions of the Companies Act, 1956 with regard to the remuneration of an auditor? [Nov, 1995, Question 2(b); 4 marks]

2. How is the Auditor's remuneration required to be disclosed in the company's Profit and Loss Account. [Nov, 1995, Question 2(c); 4 marks]

3. During the audit of a company's accounts, the directors bring the following matters to your attention as not being reflected in the company's accounting records:

   (a) A decision was taken shortly before the year end to pay an interim dividend of Rs.10,000 on Equity Capital one month after the year end date.

   [Nov, 1995, Question 3(a); 6 marks]

   (b) Plant to the value of Rs.10,000 was ordered before the year end but has not been delivered. [Nov, 1995, Question 3(b); 4 marks]

   (c) The company has lost a legal action, which has been pending for two years and will have to pay Rs.1,000 damages and Rs.2,000 costs.

   [Nov, 1995, Question 3(c); 6 marks]

State how you as auditor would verify the information given to you and give your recommendations as to how the items should be disclosed, if necessary, in the accounts or notes thereon.

4. In carrying out the "Share Transfer Audit" of your client, what aspects would be required to be examined by you as the auditor? [May, 1996, Question 4; 16 marks]

5. Your client has sought your opinion to correctly account for and/or disclose the following matters. State your views with reasons for the same:

   (a) The amount payable to suppliers of machinery under deferred payment arrangements have been shown as current liabilities. The company accepted the bills drawn by the supplier and offered its other fixed assets as a collateral security.

   [Nov, 1996, Question 2(a); 4 marks]

   (b) The debit balance in the profit and loss account is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet.

   [Nov, 1996, Question 2(b); 3 marks]

   (c) Sundry debtors include charges made for returnable packing cases.

   [Nov, 1996, Question 2(c); 3 marks]

   (d) The value of land building was not separately disclosed. Also a major repair of the roof amounting to Rs.1,00,000 was carried out during the year, without which the building would have become unusable. [Nov, 1996, Question 2(d); 4 marks]

   (e) Assets purchased under hire-purchase system were reflected at their full value and the outstanding instalments payable have been included under Sundry Creditors.

   [Nov, 1996, Question 2(e); 4 marks]

6. As an auditor, how you would react to the following situations?

   (a) One of the manufacturing unit of B Ltd. equal to 40% of the total assets was destroyed in a fire for which there was no insurance cover. The chief accountant of the company contends that the destruction of the unit took place only after the date of the Balance Sheet and therefore there was no need to make disclosure of loss in the annual accounts as at the Balance Sheet date.

   [May, 1997, Question 2(c); 4 marks]

   (b) The register of members of C Ltd. has not been written up-to-date and as a result the balances in the register do not agree with the amount of issued share capital.

   [May, 1997, Question 2(d); 3 marks]

(c) The Directors of D Ltd. want to transfer to the Profit and Loss Account a large sum lying in unclaimed dividends account. The dividends remained unclaimed over the last three years. [May, 1997, Question 2(e); 3 marks]

7. How audit would be carried out of shares issued for consideration other than cash?

[May, 1998, Question 3(b); 8 marks]

8. As an auditor, how would you react to the following situations?

(a) The company entered into "an agreement for sale" to purchase an office space in a commercial complex. The company with the consent of the promoters started operations from the said place upon signing of the said agreement and included under fixed assets, the total consideration payable.

[Nov, 1998, Question 1(b); 5 marks]

(b) The company due to liquidity crisis sold and leased back the same vehicles from two different leasing companies on the same terms and conditions. In the notes to accounts the company stated "vehicles taken on lease repayable in 36 instalments of Rs.36,650 each".

The company was of the view that since the total monthly instalments payable was disclosed in totality, no qualification was required to be made by the auditor.

[Nov, 1998, Question 1(d); 5 marks]

9. As an auditor, comment on the following situation/statement:

Z Ltd. acquired a car for its Managing Director on Hire-purchase basis. The interest payable as well as penalty payable for late payment of instalments was added to the cost of the car. [May, 1999, Question 2(c); 5 marks]

10. Your firm has been appointed as auditor of ABC Ltd. State your opinion on the following matters:

(a) ABC Ltd. had acquired an asset from U.S.A. at a cost of US $1,00,000. Immediately after acquisition of the asset, the Indian Rupee was devalued by 10%. The company transferred the additional liability to Exchange Fluctuations Reserve Account. [May, 1999, Question 3(a); 4 marks]

(b) Calls in Arrears included an amount of Rs.20,000 due from Directors of the company. The Articles of Association provided for charging interest on calls in arrears. The company did not provide interest on the amount due from Directors.

[May, 1999, Question 3(b); 4 marks]

11. Comment on the following:

    (a) While conducting the audit of a limited company for the year ended 31st March, 1998, the auditor called for the ledger for ascertaining the details of a particular account. The ledger could not be made available to him as it was destroyed due to space constraint as per the instruction of the Executive Director of the company.

    [Nov, 1999, Question 1(iv); 4 marks]

    (b) S. Ltd. had issued debentures, which had been guaranteed by the Government of India both as to the repayment of the principal and interest. The company disclosed the same as "Secured Loans" in their Balance Sheet.

    [Nov, 1999, Question 1(v); 5 marks]

    (c) The surplus arising from a change in the basis of accounting was set off by X Ltd., against a non-recurring Loss. [May, 2000, Question 1(c); 4 marks]

    (d) Z Ltd. gave a guarantee tot he court for payment of Excise dues of Rs.10 lakhs for one of its subsidiaries. According to the company, since the guarantee was given on behalf of its subsidiary no disclosure was required.

    [May, 2000, Question 1(d); 4 marks]

12. State your opinion on the following:

    The surplus arising from sale of investments was set-off against a non-recurring loss and was not disclosed separately. [May, 2000, Question 2(d); 4 marks]

13. State briefly, how you will audit the following in a joint stock company:

    (a) Reduction of Share Capital [Dec, 1999, Question 5(a); 6 marks]

    (b) Provision for Gratuity [Dec, 1999, Question 5(b); 5 marks]

    (c) Redemption of Preference Shares [Dec, 1999, Question 5(c); 5 marks]

14. State your opinion/comment on the following:

    (a) Credit for the profit arising out of a Hire-purchase Sale was fully adjusted in the year of Sale. [May, 2000, Question 2(c); 4 marks]

    (b) Interest on Share Capital was paid to the shareholders as the company had a long gestation period before it could become operational.

    [May, 2000, Question 2(e); 4 marks]

15. As an auditor comment on the following situations:

    (a) A company had acquired a 10 Tonner delivery van valued at Rs.6.5 lakhs on instalment basis from a dealer. During the year, the company paid Rs.1.5 lakhs

being the instalment for the year and provided depreciation on the said amount paid. [May, 2000, Question 3(a); 4 marks]

(b) A sum of Rs.15,000 per month has been paid as remuneration to a Director, who is not in the whole-time employment of the company.

[May, 2000, Question 3(b); 4 marks]

(c) A company received a subsidy of Rs.1 crore for establishing an undertaking in the backward/notified area. [May, 2000, Question 3(d); 4 marks]

16. State your opinion/comment on the following:

(a) The interest of a director in a transaction, entered into by the company has not been disclosed in the records maintained by the company.

[May, 2000, Question 5(c); 4 marks]

(b) The auditor is responsible for failure to disclose the affairs of the company kept out of books and concealed from him. [May, 2000, Question 5(d); 4 marks]

17. As an auditor, what would you do in the following situations?

(a) One customer from whom Rs. 5 lacs are recoverable for credit sales gives a motor car in full settlement of the dues. The directors estimate that the market value of the motor car transferred is Rs. 5.25 lacs. As on the date of the balance sheet the car has not been registered in the name of the auditee.

[Nov, 2000, Question 1(b); 4 marks]

(b) The company had borrowed Rs.100 lacs from ICICI, which it is unable to repay on the due date. The accrued unpaid interest on the same is Rs.25 lacs. There is a stipulation that on default in repayment, there would be a penal interest payable, which would amount to Rs. 10 lacs. The company has applied to ICICI for rescheduling the repayment and waiver of a part of the accrued interest and the penal interest. As on the date of audit, the said application is still pending.

Based on this application, the management does not wish to provide for the accrued interest and the penal interest. [Nov, 2000, Question 1(c); 5 marks]

20. State briefly, how will you audit the following in a joint stock company:

(a) Issue of shares for consideration other than cash.

[Nov, 2000, Question 7(a); 6 marks]

(b) Buy-back of shares by the company. [Nov, 2000, Question 7(b); 5 marks]

(c) Splitting of one share of the face value of Rs.10 into 10 shares of Re. 1 each.

[Nov, 2000, Question 7(c); 5 marks]

21. Explain the difference between Reserves and Provisions

[May, 2001, Question 4(c), 5 marks]

22. In carrying out the "Share Transfer Audit" of your client, what aspects would be required to be examined by you as an auditor? [May, 2001, Question 5, 16 marks]

23. Explain 'Option on Share Capital' [May, 2001, Question 7(b), 4 marks]

24. Give your comments and observations on the following:

(a) A company has not provided depreciation on machinery on the plea that the machinery has been maintained in excellent condition and is as good as new.

[Nov, 2001, Question 1(a), 5 marks]

(b) A company, whose accounting year ends on 31st March, 2001 has placed an order with Globe Machinery Limited, Bombay for a machinery costing Rs.20 lakhs against cash payment during the month of June, 2001. The company has added a foot-note to the Balance Sheet as at 31st March, 2001 showing separately that a capital contract has been entered into which requires the payment of Rs.20 lakhs in cash.

[Nov, 2001, Question 1(b), 4 marks]

(c) A company has scrapped a semi-automatic part of a machine (not entirely written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to a more suitable place in the factory, which involved the building of a new foundation in addition to the cost of dismantling and re-erection. The company wants to charge the whole expenditure to revenue. [Nov, 2001, Question 1(c), 5 marks]

(d) A company has made additions to its factory buildings by its own workmen, at a cost of Rs.4,50,000 for wages and materials. The lowest estimate from an outside contractor to carry out the same work was for Rs.6,00,000. The directors contend that as they were fully entitled to employ an outside contractor, it is reasonable to debit the Factory Building Account with Rs.6,00,000.

[Nov, 2001, Question 1(d), 4 marks]

25. As a Company Auditor how would you react to the following situations?

(a) A publishing company undertook repair and overhauling of its machinery at a cost of Rs.250 lakhs to maintain them in good condition and capitalised the amount as it is more than 25% of the original cost of the machinery.

[Nov, 2002, Question 2 (a), 3 marks]

(b) Inventories of a Car manufacturing company include the value of items, required for the manufacture of a model which was removed from the production line rive years back, at cost price. [Nov, 2002, Question 2 (b), 3 marks]

(c) Interest on loan borrowed to purchase a machinery which has been installed two years back is still debited to Machinery Account.

[Nov, 2002, Question 2 (c), 3 marks]

(d) Sale value of scrap items adjusted against Miscellaneous Expenditure

[Nov, 2002, Question 2 (d), 3 marks]

(e) Insurance claim of Rs. 2 lakhs received stands included under Miscellaneous Income. [Nov, 2002, Question 2 (e), 3 marks]

(f) Rs. 5 lakhs paid by a pharma company to the legal advisor defending the patent of a product treated as Capital Expenditure. [Nov, 2002, Question 2 (f), 3 marks]

26. As an auditor comment on the following situations/statements:

(a) The sale and purchases of investments of A Ltd., was controlled through a committee. Shri B sold some of the investments without discussing the same with the other members of the committee as they were out of station and Shri B believed that its price would fall and the company would suffer a loss if it is not sold. A Ltd. earned a profit of Rs.1 lakh from such sale. [May, 2003, Question 1 (a), 6 marks]

(b) The company due to liquidity crises sold and leased back the same vehicles from leasing companies. In the notes to accounts, the company stated 'Vehicles taken on lease repayable in 46 instalments of Rs.26,650 each'.

[May, 2003, Question 1 (b), 6 marks]

(c) No depreciation provided on a machinery costing Rs.50 lakhs imported three years back, since it is yet to be put into use. [May, 2003, Question 1 (c), 3 marks]

(d) A portion of Share Premium utilised to declare 40% dividend.

[May, 2003, Question 1 (d), 3 marks]

27. Give your comments on the following:

(a) M/s Verma and Sharma, Chartered Accountants were appointed as the first auditors of Good Luck Ltd. By virtue of their name being included as auditors in the Articles of Association. [May, 2003, Question 2 (a), 3 marks]

(b) The auditors were requested by the management to accept the draft minutes of Board, since the minutes book has been misplaced

[May, 2003, Question 2 (b), 3 marks]

(c) The Board of Directors removed the first auditors before the expiry of the term and appointed another auditor in his place. [May, 2003, Question 2 (c), 3 marks]

(d) The auditors are being insisted by the management to hand over the letters of confirmation of balances received by the auditor from debtors and creditors.

[May, 2003, Question 2 (d), 3 marks]

(e) No cost accounting records are maintained though the company is required to maintain the same. [May, 2003, Question 2 (e), 3 marks]

(f) A Government company appointed the auditors and fixed the remuneration in its general meeting. [May, 2003, Question 2 (f), 3 marks]

28. Comment on the following:

(a) ABC Ltd. has not deposited provident fund contributions of Rs.20 lakhs to the authorities, but accounted in the books.

(b) Asian Overseas Oil Ltd.'s oil wells were damaged in Iraqi war in November, 2002. Claim preferred with the Insurance Companies for total loss. Pending the settlement by the Insurance Companies for total loss. Pending the settlement by the Insurance Companies neither any provision nor any disclosure has been made in 2002-03 accounts.

(c) Sundry debtors of a company as an 31-3-03 include Rs.10 lakhs from M/s Unreliable Traders, who have been declared as insolvent on 4-4-2003.

(d) Directors of Speedway Ltd. declared a final dividend of 30% for 2002-03 in their meeting held on 11-8-2003.

(e) During the year under audit, A Ltd. credited to the Profit & Loss Account, the entire profit of Rs. 5 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit.

(f) Inspite of the internal control weakness commented upon by the audit manager, no further tests need to be carried out, as the purchase and sales figure as a



percentage of gross profit was same as in the previous year. The audit manager's comments were in regard to control over purchases and sales.

[Nov., 2003, Question 2(a), (b), (c) & (d) 3 marks each]

29. What is the meaning of "options on unissued share capital" of a company?

[Nov, 2003, Question 5 (b), 4 marks]

30. As an auditor, comment on the following situations/statements:

(a) The method of depreciation on Plant and Machinery is to be changed from SLM basis to WDV basis from the current year. (4 marks)

(b) The Finance Manager of Belt Ltd. is of the opinion that before declaration of dividends it would not be necessary to set off the carried forward amount of debit balance in the Profit and Loss Account against current revenue profit but the same could be set-off against existing revaluation reserve. Do you agree? (5 marks)

(c) Ganga-Kaveri Project Ltd. was incorporated on 1.7.2002. During the year ended 31.3.2003 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore the Chief Accountant of the company contends that for the relevant year there was no need to prepare a statement of profit or loss or any other statement except a Balance Sheet as at 31.3.2003. (5 marks)

(d) The company has sent semi-finished goods to third parties for further processing which is lying with them at the end of the year. (4 marks)

[May, 2004, Question 1 (a), (b), (c) & (d)]

31. Draft an illustrative Audit Report u/s 227 of the Companies Act, 1956, with a few qualifications. Annexure u/s 227(4A) is not required. [May, 2004, Question 5, 16 marks]

32. How will you vouch and/or verify the following?

(a) Contingent Liabilities

(b) Excise Duty

(c) Recovery of Bad-debts written off

(d) Endowment Policies [May, 2004, Question 6, 4×4 = 16 marks]

33. As an auditor, comment on the following situations/statements:

(a) You are the Auditor of a Manufacturing Company, whose year ends on 31st March. An event occurred after the year ended, but before you complete the audit. The audit report issued by you is dated 20th July. The Sales Ledger balance at 31st

March was Rs. 95, 000. By 20th July Rs. 65,000 only had been received against this amount as full and final payment. (4 marks)

(b) AAS Ltd. Is procuring the packing materials from M/s XY and Co., a partnership firm consisting of Mr. X and Mr. Y. Mr. Y is the Managing Director of AAS Ltd. The total value of purchases made from XY and Co. by AAS Ltd. During the year 2003-04 had been Rs. 38 lakhs. (4 marks)

(c) X Ltd. is good in profits, but suffers temporarily in liquidity. It proposes to declare dividend of 10% in annual general meeting, but the Board proposes to defer payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM (4 marks)

(d) A Computerised Machinery was purchased by two companies jointly. The price was shared equally. It was also agreed that they would use the machinery equally and show in their Balance Sheets, 50% of the value of the machinery and charge 50% of the depreciation in their respective books of accounts. (4 marks)

[Nov, 2004, Question 1 (a), (b), (c) & (d)]

34. Explain the various types of companies under Companies (Auditor's Report) Order, 2003

[Nov, 2004, Question 3(b) 8 marks]

35. As an auditor, comment on the following situations/statements:

(a) Z Ltd. had the following items under the head "Reserves and Surplus" in the Balance Sheet as on 31st March, 2004:

	Amount Rs. in lacs
Securities Premium Account	80
Capital Reserve	60
General Reserve	90

The company had an accumulated loss of Rs. 40 lacs on the same date, which it has disclosed under the head "Profit and Loss Account" on the assets side of the Balance Sheet. (4 marks)

(b) A Ltd. has its Registered Office at New Delhi. During the current accounting year, it has shifted its Corporate Head Office to Indore though it has retained the Registered Office at New Delhi. The Managing Director of the Company wants to shift its books of account to Indore from New Delhi, as he feels that there is no legal bar in doing so. (4 marks)

(c) The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts were considered. (5 marks)

(d) The auditor of a company wanted to see the minutes book of Directors meetings. The Chairman of the company refused for the same on the ground that matters of confidential nature were contained therein. (5 marks)

[May, 2005, Question 1(a), (b), (c) & (d)]

36. What categories of companies are specifically exempted from the application of Companies (Auditor's Report) Order, 2003? [May, 2005, Question 2 (b), 8 marks]

37. Discuss the concept of "True and Fair" [May, 2005, Question 4 (b), 8 marks]

Short Notes

(a) Preliminary Expenses [Nov, 2000, Question 8(a); 4 marks]

(b) Sweat Equity Shares [Nov, 2000, Question 8(d); 4 marks]

(c) Audit of Capital Reserve [May, 2002, Question 8(d), 4 marks]

(d) Option on Share Capital [Nov, 2002, PE-II, Question 8(d), 4 marks]

(e) Sweat Equity Shares [May, 2003, Question 8(c), 4 marks]

(f) Audit enquiry under Section 227(1A) [Nov, 2004, Question 8(b), 4 marks]

(g) Statutory Report of a Public Company under section 165()

[May, 2006, Question 8(a), 4 marks]

IX. Special Audits

1. Comment on the following statement:

   Generally an audit is not concerned with the propriety of business conduct.

   [May, 1995, Question 1(c); 6 marks]

2. (a) What do you understand by the term 'Government Auditing'?

   [May, 1995, Question 7(a); 8 marks]

   (b) Discuss the duties of C & AG within the framework of the Constitution of India.

   [May, 1995, Question 7(b); 8 marks]

3. (a) What are the important features of distinction between computer based system of accounting and those of a conventional nature? [Nov, 1995, Question 6(a); 4 marks]

(b) What are the administrative controls which ensure an acceptable standard of discipline and efficiency in a computer based accounting system?

[Nov, 1995, Question 6(b); 12 marks]

4. What special steps are involved in conducting the audit of a college?

[Nov, 1995, Question 7; 16 marks]

5. Mention the important items to be examined by the auditor in the audit of a Hospital.

[May, 1996, Question 7; 16 marks]

6. What considerations are to be kept in mind while conducting audit of the leasing transaction of a leasing company? [Nov, 1996, Question 7; 16 marks]

7. Mention the important matters requiring the attention of the auditor in the audit of a charitable institution. [May, 1997, Question 6; 16 marks]

8. In respect of Government Audit, explain:

(a) Propriety Audit [Nov, 1997, Question 4(a); 6 marks]

(b) Audit of Stores and Stocks [Nov, 1997, Question 4(b); 6 marks]

(c) Powers of the Comptroller and Auditor General under Section 619(3)&(4) of the Companies Act, 1956. [Nov, 1997, Question 4(c); 4 marks]

9. Briefly state the special steps involved in audit of a club.

[Nov, 1997, Question 7(b); 10 marks]

10. What is the ideal approach while carrying out audit of incomplete records?

[May, 1998, Question 5(b); 8 marks]

11. Mention the important items to be examined by the auditor in the audit of a Hospital.

[May, 1998, Question 6; 16 marks]

12. (a) Comment on the following:

(i) Concurrent audit provides a supplementary management tool.

[Nov, 1998, Question 3(a)(i); 4 marks]

13. (a) (i) In carrying out an audit against provision of funds, what aspects would you consider? [Nov, 1998, Question 6(a)(i); 2 marks]

(ii) As an auditor, how will you react to an expenditure incurred by a government department which was sanctioned by a fellow officer of the competent authority as the concerned officer was on leave. [Nov, 1998, Question 6(a)(ii); 3 marks]

(iii) The assessing officer in order to ensure that there was no loss of revenue, increased the income of all assessees between 50% to 100%.

State your views, if you were entrusted to carry out an audit of receipt of the said assessing department. [Nov, 1998, Question 6(a)(iii); 3 marks]

(b) State the special points you as an auditor will consider while conducting the audit of a cinema. [Nov, 1998, Question 6(b); 8 marks]

14. Mention the special points to be examined by the auditor in the audit of a Charitable Institution running a dispensary in a small village which charges Re. 1 per patient per visit irrespective of the disease. [May, 1999, Question 7; 16 marks]

15. (a) Discuss the provision of the Constitution of India to safeguard the independence of the Comptroller and Auditor General of India. [Nov, 1999, Question 7(a); 8 marks]

(b) Mention briefly eight special points you as an auditor would consider in conducting the audit of club. [Nov, 1999, Question 7(b); 8 marks]

16. State your views on the following:

(a) Government audit serves as a mechanism for public accounting of Government funds. [Dec, 1999, Question 6(b); 4 marks]

(b) Government audit functions as an investigation agency.

[Dec, 1999, Question 6(c); 4 marks]

17. Mention the special steps involved in the audit of an Educational Institution.

[May, 2000, Question 7; 16 marks]

18. Mention the special points to be examined by the auditor in the audit of a charitable institution running hostel for students pursuing the Chartered Accountancy Course and which charges only Rs.500 per month from a student for his lodging / boarding.

[Nov, 2000, Question 6; 16 marks]

19. Mention the special points in the case of an audit of the entity from Incomplete Records.

[May, 2001, Question 7(a), 12 marks]

20. (b) An audit of Expenditure is one of the major components of Government Audit. In the context of 'Government Expenditure Audit', write in brief, what do you understand by:

(i) Audit against Rules and Orders

(ii) Audit of Sanctions

(iii) Audit against Provision of Funds

(iv) Propriety Audit

(v) Performance Audit [Nov, 2001, Question 5(b), 5 marks]

(c) What role is played by Comptroller and Auditor General of India in the audit of a Government company? [Nov, 2001, Question 5(c), 3 marks]

21. Draft an Audit Programme to audit the accounts of a Recreation Club with facilities for indoor games and in-house eating. [May, 2002, Question 6, 18 marks]

22. Mention eight important items to be examined by the auditor in the Audit of a Hospital.

[Nov., 2002, Question 7(a), 8 marks]

23. How will you conduct the audit of Incomplete Records

[Nov., 2002, Question 6(b), 8 marks]

24. Explain the audit procedure for conducting the audit of a Non-governmental Organisation (NGO)? [Nov., 2002, Question 7, 16 marks]

25. Explain in detail the duties of Comptroller and Auditor General of India.

[May, 2003, Question 6(a) 8 marks]

26. Mention any eight special points which you as an auditor would look into while auditing the books of a partnership firm. [May, 2003, Question 7(a) 8 marks]

27. (a) What is the ideal approach while carrying out audit of Incomplete Records?

[Nov, 2003, Question 7(a) 8 marks]

(b) An Audit of expenditure is one of the major components of Government Audit. In the context of "Government Expenditure Audit" write in brief, what do you understand by:

(i) Audit against Rules and Orders

(ii) Audit of Sanctions

(iii) Audit against Provision of Funds

(iv) Propriety Audit

(v) Performance Audit. [May, 2003, Question 7(b) 8 marks]

28. Mention the important items to be examined by the auditor in the receipt of Income of Non-Governmental Organisations (NGO's). [May, 2004, Question 7(a) 10 marks]

29. Describe the salient features of Financial Administration of Local Bodies.

[Nov, 2004, Question 4(a) 8 marks]

30. What are the special steps involved in conducting the audit of an Educational Institution?

[Nov, 2004, Question 6, 16 marks]

31. With reference to Government Audit, what do you understand by "Audit of Commercial Accounts". [May, 2005, Question 3(a), 8 marks]

32. (a) What special steps will you take into consideration in auditing the accounts of a hotel. (10 marks)

(b) Medical Council of India organised a three-day International Conference of Doctors in Delhi. You are asked to audit the accounts of the conference. Draft the audit programme for audit of receipt of participation fees from delegates to the conference. Mention any six points, peculiar to the situation, which you will like to include in your audit programme. (6 marks)

[May, 2005, Question 6(a) & (b)]

33. What are the powers of C&AG in relation to the accounts of Government Companies audited by the statutory auditors? [Nov., 2005, Question 5(a), 8 marks]

34. (a) An NGO operating in Delhi had collected large scale donations for Tsunami victims. The donations so collected were sent to different NGOs operating in Tamil Nadu for relief operations. This NGO operating in Delhi has appointed you to audit its accounts for the year in which it collected and remitted donations for Tsunami victims. Draft audit programme for audit of receipts of donations and remittance of the collected amount to different NGOs. Mention six points each, peculiar to the situation, which you will like to incorporate six points each, peculiar to the situation, which you will like to incorporate in your audit programme for audit of said receipts and remittances of donations.

(b) What special steps will you take into consideration in auditing the receipts from entry fees of an amusement part? Mention any four points specific to the issue.

[Nov., 2005, Question 6(a) & (b), 12+4 marks]

35. Explain propriety audit in the context of Government Audit

[May, 2006, Question 5 (b) 8 marks]

36. How the audit is advantageous to Sole Trader? [May, 2006, Question 6 (b) 8 marks]

Short Notes

(a) Audit of Government Expenditure by Comptroller and Auditor General.

[May, 1996, Question 8(c); 4 marks]

(b) Audit of a Government Companies [Nov, 1996, Question 8(a); 8 marks]

(c) Audit of Government Expenditure [Nov, 1996, Question 8(b); 8 marks]

(d) Propriety audit [May, 1997, Question 8(a); 8 marks]

(e) Performance Audit [May, 1998, Question 8(b); 5 marks]

(f) Expenditure Audit of Government Organisations / Departments. [May, 1999, Question 8(a); 4 marks

(g) Performance Audit [May, 2000, Question 8(a); 4 marks]

(h) Propriety Audit [Nov., 2002, Question 8(b), 5 marks]