

VOUCHING

BASIC CONCEPTS

Vouching

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.

Audit of cash transactions

A. General Considerations

- (i) Internal Control System
- (ii) Correctness of book-keeping records
- (iii) Observance of accounting principles.
- (iv) Evidence of Transactions.

- (v) Validity of Transactions
- (vi) Disclosure in the Final Accounts

B. Casting or Totalling

Sometimes the totals of a wage bill are inflated by over totalling the column in which the wages payable are entered. 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

C. 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.

Audit of trading transactions

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*
- (ii) *Observance of accounting principles*
- (iii) *Checking of stock and record :*

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 fore goings.

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. 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.

Cut-off arrangement

It is the arrangement where the transactions of one period would be separated from those in the ensuing period so that the results of the working of each period can be correctly ascertained.

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.

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

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

Question 1

How will you vouch and/or verify the following?

- (a) *Recovery of Bad Debts written off*
- (b) *Goods sent out on Sale or Return Basis*
- (c) *Borrowing from Banks*

Answer

(a) Recovery of Bad Debts written off

- (i) Ascertain the total amount of bad debts.
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- (ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.
- (iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.
- (iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(b) Goods sent out on sale or return basis

- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- (ii) See that price of such goods is unloaded from the sales account and the debtor's record. 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.
- (iii) Ensure 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.
- (iv) Confirm 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 lying with the party, has been included in the closing stock.

(c) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

- (i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.
- (ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.
- (iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

- (iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

Question 2

Give your comments and observations on the No entry is passed for cheques received by the auditee on the last day of the year, but not yet deposited with the bank.

Answer

Cheques Received on the last day of Accounting Year: It is a quite normal that in any on going business entity many a time's cheques are received from the customers on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking, it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view.

As far as internal control system is concerned, it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the debtors' ledger should ensure that proper accounting entries have been passed by crediting respective debtors' accounts. The balance of cheques-in-hand should also be disclosed along with the cash and bank balances in the financial statements.

Question 3

How will you vouch/verify the following:

- (a) *Goods sent on consignment*
- (b) *Foreign travel expenses*
- (c) *Receipt of capital subsidy*
- (d) *Provision for income tax*

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Answer

(a) Goods Sent on Consignment

- (i) Verify the accounts sales submitted by the consignee showing goods sold and stock of goods in hand.
- (ii) Reconcile the figure of the goods on hand, as given in the last accounts sales, with the Performa invoices and accounts sales received during the year. If any consignment stock was in the hands of the consignee at the beginning of the year, the same should be taken into account in the reconciliation.
- (iii) Obtain confirmation from the consignee for the goods held on consignment on the balance sheet date. Verify the terms of agreement between the consignor and the consignee to check the commission and other expenses debited to the consignment account and credited to the consignee's account. The accounts sales also must be correspondingly checked.
- (iv) Ensure that the quantity of goods in hand with the consignee has been valued at cost plus proportionate non-recurring expenses, e.g., freight, dock dues, customs due, etc., unless the value is lower. In case net realisable value is lower, the stock in hand of the consignee should be valued at net realisable value. Also see that the allowance has been made for damaged and obsolete goods in making the valuation.
- (v) See that goods in hand with the consignee have been shown distinctly under stocks.

(b) Foreign Travel Expenses

- (i) Examine T.A. bills submitted by the employees stating the details of tour, details of expenses, etc.
- (ii) Verify that the tour programme was properly authorised by the competent authority.
- (iii) Check the T.A. bills along with accompanying supporting documents such as air tickets, travel agents bill, hotel bills with reference to the internal rules for entitlement of the employees and also make sure that the bills are properly passed.
- (iv) See that the tour report accompanies the T.A. bill. The tour report will show the purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report conforms to the authorisation for the tour.
- (v) Check Reserve Bank of India's permission, if necessary, for withdrawing the foreign exchange. For a company the amount of foreign exchange spent is to

be disclosed separately in the accounts as per requirement of Part I of Schedule VI to the Companies Act, 1956.

(c) Receipt of Capital Subsidy

- (i) Refer to application made for the claim of subsidy to ascertain the purpose and the scheme under which the subsidy has been made available.
- (ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.
- (iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.
- (iv) Check relevant entries for receipt of subsidy.
- (v) Check compliance with requirements of AS 12 on "Accounting for Government Grants" i.e. whether it relates to specific amount or in the form of promoters' contribution and accordingly accounted for as also compliance with the disclosure requirements.

(d) Provision for Income Tax

- (i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc

Question 4

'In vouching payments, the auditor does not merely check proof that money has been paid away.' Discuss.

Answer

Vouching is a substantive audit procedure which aims at verifying the genuineness and validity of a transaction contained in the accounting records. It involves examination of documentary evidence to support the genuineness of transaction. Thus the object of vouching is not merely to ascertain that money has been paid away; but the auditor aims to

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obtain reasonable assurance in respect of following assertions in regard to transactions recorded in the books of account that –

- (i) a transaction is recorded in the proper account and revenue or expense is properly allocated to the accounting period;
- (ii) a transaction pertains to entity and took place during the relevant period;
- (iii) all transactions which have actually occurred have been recorded;
- (iv) all transactions were properly authorised; and
- (v) transactions have been classified and disclosed in accordance with recognised accounting policies and practices.

Thus, it is through vouching that the auditor comes to know the genuineness of transactions recorded in the client's books of account wherefrom the financial statements are drawn up.

Apart from genuineness, vouching also helps the auditor to know the regularity and validity of the transaction in the context of the client's business, nature of the organisation and organisational rules.

Thus, the auditor's basic duty is to examine the accounts, not merely to see its arithmetical accuracy but also to see its substantial accuracy and then to make a report thereon.

This substantial accuracy of the accounts and emerging financial statements can be known principally by examination of vouchers which are the primary documents relating to the transactions. If the primary document is wrong or irregular, the whole accounting statement would, in turn, become wrong and irregular. Precisely auditor's role is to see whether or not the financial statements are wrong or irregular, and for this, vouching is simply imperative. Thus, vouching which has traditionally been the backbone of auditing does not merely involve checking arithmetical accuracy but goes much beyond and aims to check the genuineness as well as validity of transactions contained in accounting records

Question 5

How will you, as an auditor, vouch and/or verify the following ?

- (i) *Deferred Revenue Expenditure*
- (ii) *Goodwill*

Answer

- (i) **Deferred Revenue Expenditure:** This is a type of revenue expenditure, whose benefit extends to more than one accounting year during which it is actually incurred. Accountancy principles require that only that part of the expenditure which is pertaining to the accounting period should be debited to the profit and loss account of

the year. Remaining amount should be carried forward in the balance sheet and it should be written off against the future income, depending upon the number of years during which the benefit of expenditures is likely to be enjoyed. This type of expenditure is known as deferred revenue expenditure. Part of such revenue expenditure is to be treated as assets for the purpose of disclosure in the balance sheet for the time till the benefit of such expenditure is fully exhausted.

Some examples of deferred revenue expenditure are expenditure on an advertisement campaign to launch a product in the market, discount allowed on subscription to debentures, development expenses in the case of mines and plantations, etc. While verifying deferred revenue expenditure, this may satisfy himself that:

- (a) it is proper to defer the expenditure;
- (b) the period of amortisation of the expenditure is reasonable;
- (c) the expenditure shown to have been incurred during the year actually occurred during the year and there is proper authority for the expenditure and for its deferral;
- (d) the criteria which previously justified the deferral of the expenditure continue to be met and the expected future revenue / other benefits related to the expenditure continue to exceed the amount of unamortized expenditure.

(ii) Goodwill:

- (a) Ensure that goodwill has been recorded in the books only when some consideration in money or money's worth has been paid for. Goodwill arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.
- (b) Check the vendor's agreement on the basis of which assets of the running business have been acquired by the company at a price existing in the book value of the assets or where a specific sum has been paid for the goodwill.
- (c) See that only the amount paid to the vendors not represented by tangible assets has been debited to the goodwill account. Therefore, it is not prudent that goodwill should be shown in the company's accounts by way of writing up the value of its assets on revaluation or writing back the amount of goodwill earlier written off by the company.
- (d) See whether goodwill has been written off as a matter of financial prudence.

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Question 6

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.*

Answer

(a) Sale Proceeds of Scrap Material

- (i) Review the internal control on scrap materials, as regards its generation, storage and disposal and see whether it was properly followed at every stage.
- (ii) Ascertain whether the organisation is maintaining reasonable records for the sale and disposal of scrap materials.
- (iii) Review the production and cost records for determination of the extent of scrap materials that may arise in a given period.
- (iv) Compare the income from the sale of scrap materials with the corresponding figures of the preceding three years.
- (v) Check the rates at which different types of scrap materials have been sold and compare the same with the rates that prevailed in the preceding year.
- (vi) See that scrap materials sold have been billed and check the calculations on the invoices.
- (vii) Ensure that there exists a proper procedure to identify the scrap material and good quality material is not mixed up with it.
- (viii) Make an overall assessment of the value of the realisation from the sale of scrap materials as to its reasonableness.

(b) Trade Marks and Copyrights

- (i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.
- (ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trade marks and copyrights have been duly registered.

- (iii) Verify existence of copyright by reference to contract between the author and noting down the terms of payment of royalty.
- (iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trade marks and copyrights have been capitalised.
- (v) Verify existence of copyright by reference to contract between the author and the entity and to check the payments of royalty made to author.
- (vi) Ascertain that the legal life of the trade marks and copyrights have not expired.
- (vii) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations.

(c) Machinery acquired under Hire-purchase system

- (i) Examine the Board's Minute Book approving the purchase on hire-purchase terms.
- (ii) Examine the hire-purchase agreement carefully and note the description of the machinery, cost of the machinery, hire purchase charges, terms of payment and rate of purchase.
- (iii) Assets acquired under Hire Purchase System should be recorded at the full cash value with corresponding liability of the same amount. In case cash value is not readily available, it should be calculated presuming an appropriate rate of interest.
- (iv) Hire purchased assets are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof. The interest payable along with each installments, whether separately or included therein should be debited to the interest account and not to the asset account.

(d) Work-in-Progress

The audit procedures regarding work-in-progress are similar to those used for raw materials and finished goods. However, the auditor has to carefully assess the stage of completion of the work-in-progress for assessing the appropriateness of its valuation. For this purpose, the auditor may examine the production/costing records (i.e., cost sheets), hold discussions with the personnel concerned, and obtain expert opinion, where necessary. The auditor may advise his client that where possible the work-in-progress should be reduced to the minimum before the closing date. Cost sheets of work-in-progress should be verified as follows:

- (i) Ascertain that the cost sheets are duly attested by the works engineer and works manager.

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- (ii) 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 thereof.
- (iii) Compare the unit cost or job cost as shown by the cost sheet with the standard cost or the estimated cost expected.
- (iv) Ensure that the allocation of overhead expenses had been made on a rational basis.

Compare the cost sheet in detail with that of the previous year. If they vary materially, investigate the cause thereof.

Question 7

State briefly how you will verify the following:

- (a) *Building*
- (b) *Bank Balances*
- (c) *Bills Payable*

Answer

(a) **Building:**

- (i) Verify the cost by reference to the architect's certificate as well as the contractor's receipts for amounts paid in case building is completed during the year. 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 charges have been allocated to the account and same are reasonable.
- (ii) Check whether depreciation has been provided on a consistent basis.
- (iii) Confirm the existence of building either through physical observation or other documentary evidence.
- (iv) Check the title deeds and verify that building is owned by the entity.
- (v) Ascertain whether any charge has been created on the building. If so, the same has been disclosed.
- (vi) Examine lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc.

Also ensure that all covenants in the lease deed have been fulfilled by the client.

- (vii) If revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.
- (viii) In case of a company, check that presentation and disclosure has been as per the Part of Schedule VI to the Companies Act, 1956.

(b) Bank Balances:

- (i) Verify bank balance by reference to bank statements.
- (ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.
- (iii) 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.
- (iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.
- (v) Check the form of Balance Sheet as per Part I of Schedule VI which requires that the bank balance should be segregated as follows: (i) With Scheduled Banks. And (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. The nature of deposit in each case should be stated, e.g., current, fixed, call, etc. in case of a non-scheduled bank, its name and the maximum balance that was held by it during the year should also be disclosed.

(c) Bills Payable: These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. Steps involved in their verification are:

- (i) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.
- (ii) Trace all the entries in the Bills Payable Book to the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.
- (iii) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

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- (iv) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.
- (v) Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

Question 8

Write a short note on - Cut-off arrangement.

Answer

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 separated 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 this purpose is technically known as "cut-off arrangement". It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and stock are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and stock. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:

- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
- (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 stock 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 for perfect and correct presentation in the financial statements.

Question 9

Give your comments on the 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.

Answer

Verification of Sale Proceeds of Scrap

An auditor is required to review the production and cost records for the determination of the extent of scrap materials that may arise in a given period. Normally speaking, in the ordinary

course of his duties the auditor would expect that scrap generated in the company, if any, are properly accounted for. The existence of an accounting and costing system would provide evidence about the adequacy and reliability of accounting records. The records should adequately show the details of sale of scrap. Besides the rates at which the scrap have been sold, correct billing of the same and their identification that good quality material has not been mixed up, are the other aspects to be examined by the auditor. As per CARO, 2003, the auditor was required to report whether the company is maintaining reasonable records for the sale and disposal of scrap.

Therefore, just because the sale proceeds are not significant and the company has a good accounting and costing system, the auditor cannot overlook other aspects.

Question 10

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.

Answer

There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that of the previous year; the most likely causes are as under:

- (i) **Increase in Sales Prices:** The selling price of the finished products may have been increased. Enquiries should be made by auditor as to whether there have been general or specific price increase and the reasons for the same. The auditor should obtain copies of the company price lists prevailing at different point of time and make the relevant comparison.
- (ii) **Reduction in Cost of Manufacturing:** The cost of manufacturing may have reduced substantially. The auditor should examine the stock and purchases records in respect of large purchases of raw materials, comparing current costs with those in the previous year and detailed information supporting the possibility should be sought from the company.
- (iii) **Alteration in Sales-mix:** The mix of sales may have been altered, resulting in the sales of more profitable items. Detailed sales analysis should be made for the period in order to ascertain whether the more profitable lines constituted a large proportion of the total sales.
- (iv) **Impact of Automation:** The mechanisation or automation of certain manufacturing processes may have resulted in considerable saving in labour cost and this possibility could be easily verified by comparisons of wages records.

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- (v) **Adherence to Cut-off Procedures:** The company cut-off procedures as regards closing stock and work-in-progress should be investigated, as any change in the procedure as compared with the previous year would cause a difference in the gross profit ratio. It should also be seen that the procedure laid down has been observed by the concerned personnel and rightly adhered to. The auditor should test relevant transaction and ensure that everything is incorporated in the financial statement.
- (vi) **Manipulating Sales:** The possibility of items which have been sent to customers on 'sale or return' basis being included in sales should be investigated, as this would give effect for increase in the rate of gross profit.

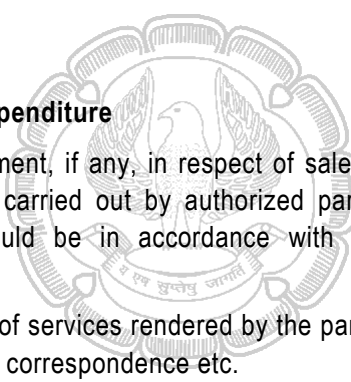
Question 11

How will you verify/vouch the following?

- (a) Sales Commission Expenditure.
(b) Sales Return.

Answer

(a) Sales Commission Expenditure

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- (1) Ascertain agreement, if any, in respect of sales transaction actually occurred during the year carried out by authorized parties on its behalf. If yes the commission should be in accordance with the terms and conditions as specified.
 - (2) Check evidence of services rendered by the party to whom commission is paid with reference to correspondence etc.
 - (3) Ensure that the sales in fact have taken place and the same has been charged to profit and loss account.
 - (4) Compare the amount incurred in previous years with reference to total turnover.

(b) Sales Return

- (i) Examine the accounting basis for such transactions with reference to corresponding Debit Note to Debit Note. The relevant correspondence may also be examined.
- (ii) Verify by reference to relevant corresponding record in good inward book or the stores records. Further, the figures in these documentary evidences should be compared with the original invoices for rates and other charges and calculation should also be checked.

- (iii) Examine in depth to eliminate the possibility of fictitious sales returns for covering bogus sales recorded earlier when such returns outwards are in substantial figure either at the start or end of the accounting year.
- (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by buyers on strength of their Debit Notes.

Question 12

Write a short note on- Vouching.

Answer

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- (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.

Question 13

As an auditor, comment on the following situation/statement:

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.

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Answer

Personal Expenses Charged to Revenue Account: As per the provisions of Section CARO 2003, the auditor shall enquire whether personal expenses have been charged to revenue account and make a report to the members in case he is not satisfied with the answer.

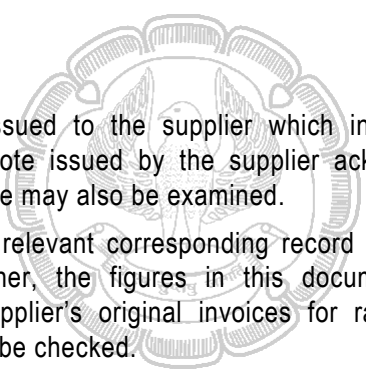
In this case, the auditor should examine documentary evidence in support of the travelling expenses of Rs.1.10 lakhs incurred by the director and ascertain the personal component thereof. Then he should enquire as to whether such personal expenses incurred by the company are covered by contractual obligations or by any accepted business practices. In case, the answer is negative, the auditor should make a report thereon and qualify his audit report.

Question 14

How will you verify/vouch the Purchase return?

Answer

Purchase Return

- 
- (i) Examine debit note issued to the supplier which in turn may be confirmed by corresponding credit note issued by the supplier acknowledging the same. The relevant correspondence may also be examined.
 - (ii) Verify by reference to relevant corresponding record in good outward book or the stores records. Further, the figures in this documentary evidence should be compared with the supplier's original invoices for rates and other charges and calculation should also be checked.
 - (iii) Examine in depth to eliminate the possibility of fictitious purchase returns for covering bogus purchases recorded earlier when such returns outwards are in substantial figure either at the beginning or end of the accounting year.
 - (iv) Cross-check with reference to original invoices any rebates in price or allowances if any given by suppliers on strength of their Credit Notes.

Question 15

Write a short note on - the Scrutiny of General Ledger.

Answer

Scrutiny of General Ledger:

- (i) 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.

- (ii) The scrutiny of General Ledger should be carried out with due care in as much as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.
- (iii) Entries in the General Ledger usually are posted in a summary form from the books of original entries such as Cash Book, Journal, Sales Book, Purchase Book and other subsidiary books. Therefore, it should be confirmed that all the postings on various accounts have been verified, totals, etc. checked.
- (iv) It should also be ascertained that balances in all the income and expense accounts have been adjusted: (a) according to standard accounting practices (i.e., all unpaid, prepaid expenses have been adjusted and accrued Income and prerecorded income is properly adjusted); and (b) on a consideration of the legal provisions which are applicable to the concern.
- (v) The balances in the General Ledger should be traced to the trial balance and from the trial balance to the final accounts.

Question 16

While conducting the audit of accounts of a manufacturing company, you discover that the rate of Gross Profit on Sales has sharply decreased in comparison to the previous year. State the steps you would take to satisfy yourself.

Answer

Rate of Gross Profit on Sales: When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause decrease in the Gross Profit of the manufacturing company:

- (i) Undervaluation of closing stock or overvaluation of opening stock either due to wrong valuation of stock or mistake in stock taking .
- (ii) Change in the basis of stock valuation. For example, opening stock was valued at market price above cost when closing stock valued at cost which is below the market price.
- (iii) Inclusion in the current year, the amount of goods purchased in the previous year, that were received and taken in the same year.
- (iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.
- (v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.
- (vi) Excess provision for wages or direct expenses have been made .

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- (vii) Goods sent out for sale on approval or on a consignment basis not included in closing stock.
- (viii) Value of unusual stock of consumable stores (fuel and packing materials) are not shown as stock or not adjusted from corresponding expenses .
- (ix) Expenses which should be charged in the in Profit and Loss Account but wrongly charged to the Trading Account.
- (x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.
- (xi) Goods sold or given as samples or destroyed, not accounted for.

Question 17

As an Auditor, comment on the following situation/statement:

SMT Enterprises entered into a contract for sale of its goods worth Rs. 24 lacs with ST Ltd. The goods were inspected, approved and finalised by the inspection team of ST Ltd. ST Ltd. made the whole payment of Rs. 24 lacs. However, it requested SMT Enterprises to dispatch the goods in six equal monthly instalments from October, 2009 to March, 2010. In the month of January, 2010, due to natural calamity, ST Ltd. informed SMT Enterprises to stop dispatches of the remaining three instalments until further notice. At the time of finalising its accounts for the financial year 2009-10, SMT Enterprises booked sales amounting to Rs. 12 lacs and showed remaining Rs. 12 lacs as Advance against Sales.

Answer

Recognition of Revenue (AS 9): AS 9 requires that revenue from sale of goods should be recognized when the following conditions are followed:

- (i) The seller has transferred the property in the goods for a price to the buyer or all significant risks and rewards of ownership have been transferred to the buyer, and the seller has not retained effective control of the goods transferred to a degree usually associated with ownership.
- (ii) No significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of goods.

In the given case, the sale transaction carried by SMT Enterprise fulfills all the condition stated above. Hence, the accounting entry passed by SMT Enterprise recognising partial revenue to the extent of goods dispatched is not correct. The entire amount of Rs. 24 lakhs should be recognised as sales.

Question 18

How will you vouch and/or verify the following:

Premium paid for insurance of a Motor car

Answer

Premium paid for insurance of a motor car: Vouch from the following:

- (i) Insurance cover note issued by the insurance company verified the car no. and period of insurance coverage.
- (ii) Verify that no claim bonus is given – where entitled – by the insurance company.
- (iii) Ensure that proper adjustment is made for pre-paid insurance premium.

Question 19

How will you vouch/verify the following?

- (a) *Liability towards gratuity*
- (b) *Expenditure incurred for promotion of a product*
- (c) *Balances with excise authority*
- (d) *Receipt of special backward area subsidy from Government.*

Answer

(a) Liability towards gratuity:

1. The liability towards gratuity payable to the employees at the time of cessation of service should be ascertained and provided for in the accounts when the employees are in service, it is an ascertained present liability accruing over the period of service but payable upon cessation of service.
2. The auditor should check the quantification of the gratuity liability. He should ascertain whether the same had been actuarially determined.
3. The auditor should treat the actuary as an expert and conduct procedures relevant to checking the opinion of an expert in accordance with SA 620.
4. The auditor should check the technical competence of actuary, the input fed to the actuary, the assumptions made by the actuary, the methodology adopted by the actuary, opinion given etc.
5. The auditor should bear in mind the relevant pronouncements of AS 15 "Employee benefits" in this regard. He should check whether the expenses of provision for gratuity are towards a defined benefit plan or contribution plan.

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6. If the contributions are made to outside agency, say the insurance companies, he should check the premium paid, the acknowledgement receipts issued by the insurance company, the coverage of policy etc. Premium due but not paid, prepaid premium etc should be appropriately accounted.
7. If the company maintains its trust for gratuity, the auditor may peruse whether the trust is an approved one under income tax law, whether the trust accounts are audited, copy of the latest accounts etc.
8. The contribution should be appropriately disclosed in the accounts as per Schedule V1 to the Companies Act, 1956.

(b) Expenditure incurred for promotion of a product

1. The expenditure incurred for promotion of a new or existing product may entail future benefits. It may be like advertisement in the papers, television, sales exhibition, participation in trade fair, issue of promotional pamphlets, free gifts etc.
2. The auditor should vouch the authority and accuracy of the transactions. He should read the contract with advertisement agencies, promotional policies decided by the management from the board minutes etc.
3. He should check the amounts paid to the agencies from bank book. He should check the accuracy, he should ascertain whether tax had been deducted in accordance with the tax law provisions if any applicable in this regard.
4. He should check whether the unpaid amounts and accrued liability towards promotional advertisement contracts had been duly provided for in the accounts.
5. The provision for fringe benefit tax in regard to sales promotion expenditure must be ascertained.
6. The huge expenditure should not be treated as deferred revenue expenditure. According to AS 26, these are not intangible assets that may be carried over the periods of accounting. These must be expensed with in the year in which these arise.

(c) Balance with excise authority

1. The balance with excise authority in PLA account should be checked with the statements of accounts/records kept with excise section of the unit.
2. The remittance into the account, the utilization out of it etc should be cross checked with bank book, clearance forms etc.

3. The balance confirmation may be checked.
4. The balance should be shown under current assets and advances in balance sheet.
5. It is to be ensured that the balances in PLA is used only to the extent of liability after adjusting cenvat credit where available.

(d) Receipt of special backward area subsidy from Government

1. The claim for backward area subsidy submitted to the authorities should be studied.
2. It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature is to facto.
3. The accounting of grant should be in accordance with AS 12 "Accounting for Government Grants" of ICAI. The revenue grant can be taken to income statement, with appropriate disclosure.
4. The capital grant may be adjusted against cost of asset or may be kept in a capital reserve to be transferred to profit and loss account each year in proportion to depreciation of that asset charged in profit and loss account.
5. The receipt of the grant should be checked with bank statement, remittance challan etc.
6. The conditions attached to grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

Question 20

As an Auditor, comment on the following:

Gear Ltd. is engaged in manufacturing and supply of gear boxes to Indian Automobile Ltd. As per terms of supply, full price of the goods are not released by Indian Automobile Ltd. but 10% thereof is retained and paid after one year, if there is satisfactory performance of the parts supplied. Gear Ltd. accounts for only 90% of the invoice value as sale at the time of supply and balance 10% is accounted as sale in the year of receipt of payment.

Answer

According to AS 9 on Revenue recognition, revenue from sale of goods should be recognised when the seller has transferred to the buyer, the property in the goods for a price or when the seller has transferred all significant risk and rewards and the seller repairs

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no effective control over goods and no significant uncertainty exists regarding the amount of consideration and its collectibility.

In the given case the goods as well as the risk and ownership has been transferred by Gear Ltd., to Indian Automobile Ltd., on the basis of invoice and delivery of material.

In the instant case, therefore, Gear Ltd., should recognise sale at full 100% of the invoice value in spite of the fact that 10% payment will be released after one year. However, depending upon the past experience regarding collectibility of 10% amount, they can make a provision for the amount that is not likely to be realised.

Hence, the treatment given by the company is not correct and if they do not correct it, the auditor should qualify his report.

Question 21

In the course of audit of a trade, you noticed that although there is no change in either selling or purchase price of the goods, there is considerable increase in Gross Profit Ratio in comparison to previous year. What matters would you examine to assess the reason for such increase?

Answer

In assessing the reason for considerable increase in Gross Profit Ratio, the auditor should examine the followings:

- (i) Under valuation of opening stock due to non-inclusion of certain items or applying lower rate to one or more items of stock.
- (ii) Over valuation of closing stock either by the inclusion of fictitious items or over valuing some of the items of Stock.
- (iii) Change in the method of valuation of opening and closing stock. For example, opening stock was valued at lower of cost and market value, whereas closing stock has been valued at market price which is higher than cost.
- (iv) Goods sold but not delivered are included in stock.
- (v) Goods delivered last year but sales invoice raised in current year.
- (vi) Recording of fictitious sales to boost up profits.
- (vii) Goods returned to supplier awarding dispatch and included in closing stock.
- (viii) Goods returned by customers but not debited to sales return and included in closing stock.
- (ix) Inclusion in the closing stock of goods received for sale on approval or consignment basis.

- (x) Treatment of goods sent on consignment basis as regular sales.
- (xi) Non-provision of outstanding expenses like wages, carriage inward etc.
- (xii) Wrong allocation of expenses in Trading and Profit & Loss Account.

Question 22

How will you vouch/verify the following?

- (a) *Sale of Investments.*
- (b) *Payment of Revenue Expenses.*
- (c) *Amount due to Subsidiary companies.*

Answer

(a) Sale of Investments

- (i) See that sale of investment has been made on the proper authorisation of Board or other competent authority.
- (ii) Ascertain the method of selling investments. It may be either through broker, directly or through a bank. See the broker's sold note.
- (iii) See that the difference between the carrying amount and the sales proceeds, net of expenses, is recognised in the Profit & Loss Account. Ensure that when only a part of the holding of an individual investment is sold, the carrying amount is allocated on the basis of average carrying amount of the total holding of the investments.
- (iv) See that proper disclosures as required by AS 13 are made as follows:
 - (1) Interest, dividends, rentals on investments are to be shown in P & L A/c at Gross Value and TDS as advance tax paid.
 - (2) Showing separately profit & Loss on disposal and changes in carrying amount of current and long term investments.

(b) Payment of Revenue Expenses

- (i) See that all payments have been duly authorised by a competent authority.
 - (ii) Ensure that all payments relates to business.
 - (iii) Ensure that all payments have been received by the correct payee and acknowledged by a receipt note or in the voucher itself.
 - (iv) See that expenses relate to the period under audit.
 - (v) Ensure that no personal expenses are charged as business expenditure.
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- (vi) See that all payments have been correctly recorded in the books under appropriate sub-head.
- (vii) See that if the payment relates to prior period it is classified so and the amount payable is correctly authorised.
- (viii) See mode of Payment cash, cheque etc., and relate to corresponding entry in cash or Bank book.
- (ix) Verify the cash memos, invoice with the amount paid.
- (x) Ensure that if any payment relates to period that extends to next year, a proportionate amount is carried forward as Pre-paid expenses.

(c) Amount due to subsidiary companies

- (i) Examine whether the subsidiary company is authorised by its memorandum of association to advance loan to its holding company.
- (ii) In the absence of such a power, see whether such power could be inferred from the other objects of the company.
- (iii) Verify the interest rate and particulars of security, if any, furnished.
- (iv) Inspect the documents executed by the holding company.
- (v) Verify the loan agreement and see that terms of loan have been duly complied with.
- (vi) Verify that the loan has been properly reflected in the Balance Sheet as per the requirements of Schedule-VI to the Companies Act, 1956.

EXERCISES

Question 1

As an auditor, comment on the following situations/statements:

- (a) 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 noted.
- (b) Z Ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch new product as Revenue Expenditure. The product did not pick up and the sales were negligible.
- (c) 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 installments was added to the cost of the car.
- (d) The sale proceeds from scrap which did not have significant value need not be verified if the company had a good accounting and costing system.

Question 2

State briefly, how would you audit following year end adjustments made by a manufacturing company:

Question 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 him that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants you to ensure the purchase have been truthfully recorded. In the circumstances, how you would proceed with the assignment?

Question 4

During the audit of company's accounts, the directors bring the following matters to your attention as not being reflected in the company's accounting records:

Question 5

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.

Question 6

How would you verify and vouch the following?

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- (a) Remuneration paid to directors.
- (b) Cash Sales.
- (c) Income-tax Payment
- (d) Proposed Dividends.
- (e) Discounted Bills Receivable dishonored.
- (f) Bills Receivable
- (g) Excise Duty
- (h) Outstanding liabilities for expenses
- (i) Sale proceeds of Rejected Materials.
- (j) Consignment transactions in the books of consignee.
- (k) Interest and Dividends received.
- (l) Preliminary expenses
- (m) Advertisement Expenses.
- (n) Refund of General Insurance Premium Paid.
- (o) Empties or Containers.

Question 7

Write short notes on the following

- (a) Outstanding Assets.
- (b) Control Accounts.

Question 8

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.
- (iii) Review of the work performed by the different personnel of the Cash Department.