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PAPER – 6: AUDITING AND ASSURANCE

Question No.1 is compulsory.

Attempt any five questions from the remaining six questions.

Question 1

Discuss on the following:

- (a) *Shares issued at a discount.* (5 Marks)
- (b) *Ceiling on number of audits in a company to be accepted by an auditor.* (5 Marks)
- (c) *Purposes of providing depreciation.* (5 Marks)
- (d) *Filling of a casual vacancy of auditor in respect of a company audit.* (5 Marks)

Answer

- (a) **Issue of Shares at a Discount:** According to Section 79 of the Companies Act, 1956, a company can issue shares at a discount on the following conditions:
 - (i) The issue should be authorised by an ordinary resolution of the company sanctioned by the Central Government
 - (ii) No such issue of shares at discount can be sanctioned by the Central Government in case the maximum rate of discount should exceed 10% unless the Central Government is of the 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 and not earlier than one year after the date of commencement of business.
 - (iv) The issue should be a class already issued by the company.
 - (v) It is the duty of the auditor to confirm that the conditions given above have been complied with by the company at the time the allotment was made.

As per the Revised Schedule VI, the unamortised discount on issue of shares should be disclosed in the balance sheet under the heading "Other Non-Current Assets/Current assets" (depending on the remaining period of amortisation).

- (b) **Ceiling on number of Audits :** According to Section 224 (1B) of the Companies Act, 1956, a Chartered Accountant cannot hold more than the specified number of company audit. This section further states that in case of Chartered Accountant Firm, the specified number is 20 companies per such partner who is not in whole time employment elsewhere. Out of the above 20 companies not more than 10 companies may have a paid up share capital of ₹ 25 lakhs or more. Explanation II after sub-section (1C) 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. Each of the joint auditors 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.

As per Companies (Amendment) Act, 2000, audit of private companies are not to be counted in computation of ceiling limit. 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 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 Council of ICAI has specified a ceiling of 30 audit assignments per person, whether in respect of private companies or other companies. In case of an audit firm, the ceiling shall be multiplied by the number of partners. Also the ceiling shall be 10 in case of public companies having paid up share capital of ₹ 25 lakhs or more.

- (c) **Purposes of Providing Depreciation:** The main purposes of providing depreciation are as under:
- (i) To keep intact the capital invested in fixed assets - This is accomplished by retaining the amount of depreciation charged in the profit and loss account in the business.
 - (ii) To ascertain the true cost of production - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.
 - (iii) To determine the profit or loss for the year - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the profit and loss account for determining the profit or loss during a year;
 - (iv) To present a true and fair value of entity's assets in the balance sheet, since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the profit and loss account representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.
- (d) **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.

Question 2

- (a) *Explain the concept of "True and Fair" view.* (6 Marks)
- (b) *Mention the areas in which differing accounting policies are encountered and how that would be disclosed?* (10 Marks)

Answer

- (a) **Concept of "True and Fair":** 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.

What constitutes "true and fair" has not been defined in the legislation. However, section 211(5) of the Companies Act, 1956 states that the balance sheet and 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 if they do not disclose any matters which are not required to be disclosed by virtue of the provisions of Schedule VI to the Companies Act, 1956, or by virtue of any notification or any order.

What constitutes a true and fair view is a matter of the auditor's judgement in the particular circumstances of the case. In specific terms to ensure truth and fairness, an auditor has to see:

- (i) that the assets are neither undervalued or overvalued;
- (ii) no material asset is omitted;
- (iii) the charge on assets, if any, is disclosed;
- (iv) material liabilities should not be omitted, and liabilities are neither undervalued or overvalued;

- (v) accounting policies have been followed consistently;
 - (vi) all unusual, exceptional, non recurring items have been disclosed separately;
 - (vii) accounts have been drawn as per requirement of Schedule VI to the Companies Act; and
 - (viii) the accounts have been drawn in compliance to the relevant accounting standards. In case of deviation from accounting standards, disclosure should be made of the reasons for such deviation and financial effects, if any arising due to such deviation
- (b) The areas in which different accounting policies may be encountered are :-
- Method of depreciation, depletion and amortization-Straight Line Method, Written Down Value method.
 - Valuation of inventories – FIFO, LIFO, weighted average etc.
 - Treatment of goodwill – write off, retain.
 - Valuation of investment –at cost, market or net realizable value etc.
 - Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.
 - Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.

Note: (The above list is not exhaustive. There may be other examples as well.)

Disclosure of Accounting Policies

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.

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.

Question 3

- (a) *What are the duties of Comptroller and Auditor General?* (10 Marks)
(b) *State any six basic elements of the Auditor's Report.* (6 Marks)

Answer

- (a) **Duties of Comptroller & Auditor General :** The Comptroller & Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 lays down duties of the C&AG as under:
- (i) *Compile and submit Accounts of Union and States* - The C&AG 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.
 - (ii) *General Provisions Relating to Audit - It shall be the duty of the C&AG –*
 - (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.
 - (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 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.
- (b) **Basic elements of the Auditor's Report:** As per SA 700(Revised), "Forming an Opinion and Reporting on Financial Statements", the auditor's report includes the following basic elements, ordinarily, in the following layout:
 - (i) Title;
 - (ii) Addressee;
 - (iii) Introductory Paragraph
 - (iv) Management's Responsibility for the Financial Statements.
 - (v) Auditor's Responsibility
 - (vi) Auditor's Opinion
 - (vii) Other Reporting Responsibilities
 - (viii) Signature of the Auditor
 - (ix) Date of Auditor's Report.
 - (x) Place of signature

Question 4

- (a) *What are the factors that are to be considered while designing a confirmation request?* (8 Marks)
- (b) *Distinguish between Auditing and Investigation.* (8 Marks)

Answer

- (a) As per SA -505 "External Confirmations", the design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the

audit evidence obtained from responses. The following factors should be considered while designing a confirmation request:-

- (i) The assertions being addressed.
 - (ii) Specific identified risks of material misstatement, including fraud risks.
 - (iii) The layout and presentation of the confirmation request.
 - (iv) Prior experience on the audit or similar engagements.
 - (v) The method of communication
 - (vi) Management's authorisation to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorisation.
 - (vii) The ability of the confirming party to provide the requested information
- (b) **Distinction between Auditing and 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.

The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Whereas investigation aims at establishing a fact or a happening or at assessing a particular situation.

Question 5

- (a) *What are the eight audit points to be considered by the auditor during the audit of a Hospital?* (8 Marks)

- (b) *As an auditor, how will you verify application and allotment money received on shares issued for cash?* (8 Marks)

Answer

- (a) **Audit of Hospital:** The audit points to be considered by the auditor during the audit of a Hospital are stated below:-

- (i) 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.
- (ii) 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.
- (iii) 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.
- (iv) Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (v) 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).
- (vi) 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.
- (vii) Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
- (viii) 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.
- (ix) Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.
- (x) See that depreciation has been written off against all the assets at the appropriate rates.
- (xi) Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.

- (xii) Obtain inventories, especially 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.
- (b) Verification of application and allotment money received on Shares Issued for Cash shall be carried out as under:

On Application

Verify the amount received along with 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.

On 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.

Question 6

- (a) *What are the audit working papers? Discuss various contents of current file.* (8 Marks)
- (b) *Explain, what are the factors to be considered while "Vouching of travelling expenses" ?* (8 Marks)

Answer

- (a) **Audit Working Papers:** Working papers are papers prepared and obtained by the auditor and retained by him, in connection with the performance of his audit. Working papers are the property of the auditor. As per SA 230 "Audit Documentation" refers to the

record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “work papers” are also sometimes used).

Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed, and the conclusions drawn from the evidence obtained.

Current Audit file: The current file normally includes:

- (i) Correspondence relating to acceptance of annual reappointment.
 - (ii) Extracts of important matters in the minutes of Board Meetings and General Meetings, as are relevant to the audit.
 - (iii) Evidence of the planning process of the audit and audit programme.
 - (iv) Analysis of transactions and balances.
 - (v) A record of the nature, timing and extent of auditing procedures performed and the results of such procedures.
 - (vi) Evidence that the work performed by assistants was supervised and reviewed.
 - (vii) Copies of communications with other auditors, experts and other third parties.
 - (viii) Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weaknesses in relevant internal controls.
 - (ix) Letters of representation or confirmation received from the client.
 - (x) Conclusions reached by the auditor concerning significant aspects of the audit.
 - (xi) Copies of the financial information being reported on and the related audit reports.
- (b) The following factors are to be considered while “Vouching of Travelling Expenses”:
- (i) 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.
 - (ii) 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.
 - (iii) The voucher for travelling expenses should normally contain the under mentioned information:
 - (1) Name and designation of the person claiming the amount.

- (2) Particulars of the journey.
- (3) Amount of railway or air fare.
- (4) Amount of boarding or lodging expenses or daily allowance alongwith the dates and times of arrival and departure from each station.
- (5) Other expenses claimed
- (iv) 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.
- (v) Particulars of boarding and lodging expenses and in the case of halting allowance the rates thereof should be verified.
- (vi) 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.
- (vii) The travelling advance taken, if any, should be settled on receipt of final bills. At the year end, the amount not settled should be shown appropriately in the Balance Sheet.
- (viii) 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.

Question 7

Write short notes on any **four** of the following:

(4 x 4 = 16 Marks)

- (a) *Audit of discounted bills receivable dishonoured.*
- (b) *Auditor's lien.*
- (c) *Inherent risk.*
- (d) *Cut-off arrangements.*
- (d) *Examination in depth.*

Answer

(a) Audit of Discounted Bills Receivable Dishonoured

- (i) Obtain the schedule of discounted bills receivable dishonoured.
- (ii) Check the entry in bank statement regarding the amount of bills dishonoured and see that the bank has debited the account of client.
- (iii) Verify the bills receivable returned by the bank along with bank's advice.

- (iv) 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.
- (v) Check that bank commission, if any, charged by the bank has been recovered from the party.
- (b) **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.

Under section 209 of the Companies Act, 1956 books of account of a company must be kept at the registered office of the company and if removed from the registered office, a resolution to this effect must be passed in a meeting of the Board of Directors and should have informed this removal to the Registrar of Companies. If this is done then only the auditor can have lawful possession. As per section 209, the auditor must provide reasonable facility for inspection of the books of account by directors and others authorised to inspect under the Act.

SA 230 issued by ICAI on Audit 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.

- (c) **Inherent risk (risk that material errors will occur):** The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. It is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterised by a large number of business failures.
- (d) **Cut-off arrangements:** 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 of 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.

- (e) **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:

- (i) The invoice and statement of account received from the supplier.
- (ii) The entry in the stock record showing that the goods were received.
- (iii) The Goods Received Note and Inspection Certificate showing that the goods on receipt were verified and inspected.
- (iv) 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 emphasized 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.