

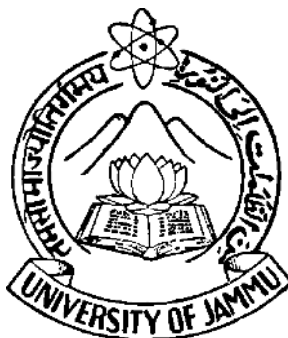
B.COM.

Semester-VI

AUDITING

C.No. BCG-603

**CENTRE FOR DISTANCE & ONLINE EDUCATION
UNIVERSITY OF JAMMU
JAMMU**



**SELF LEARNING MATERIAL
B.COM SEM.VI**

For the examination to be held in 2026 onwards

SUBJECT : AUDITING

COURSE NO. : BCG-603

UNIT : I-IV

LESSON NO. 1-12

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B. Com Semester VI

AUDITING

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UNIVERSITY OF JAMMU

B. Com Semester VI

AUDITING

C. No. : BCG 603

Time : 3 Hrs.

Max. Marks : 100

Internal Assessment : 20

External Exam : 80

OBJECTIVE

The basic objectives of this course is to acquaint the students with the knowledge and practice of audit techniques and methods so as to ensure transparency in business transaction.

UNIT - I : INTRODUCING AUDITING

Auditing - meaning, objectives; Difference between (a) Accountancy & auditing (b) Auditing & investigation. Basic Principles governing an audit as per Audit & Assurance Standard (AAS - I); Advantages & limitations of auditing; Conduct of audit; Continuous audit, Periodical audit & Interim audit; Auditing in electronic data processing (EDP) environment - Meaning, Problems & approaches.

UNIT - II : AUDIT PLANNING, INTERNAL CONTROL, INTERNAL CHECK AND INTERNAL AUDIT

Steps to be taken before commencement of an audit; Audit programme - Advantage & disadvantages. Working paper - Meaning, purpose and ownership of working papers. Internal control - Meaning, objectives, characteristics of internal control, auditors duty as regard to internal control. Internal check - Meaning, objectives, principles of a good internal check and internal audit.

UNIT - III : VOUCHING AND VERIFICATION

Vouching - Meaning, importance, kinds of vouchers; Points to be noted while vouching. Vouching of cash book. **Verification** - Meaning and objectives of verification of assets and liabilities with special reference to land and building, plant and machinery, investments, Stock-in trade, trade debtors, cash in hand, cash at bank, sundry creditors, loans, share capital & contingent liabilities.

UNIT - IV : COMPANY AUDITOR

Qualification, disqualification, appointment, removal, rights, duties & liabilities of a company auditors.
Audit Report : Meaning types - clean and qualified report.

BOOKS RECOMMENDED

1. R. G. Saxena : Principles and Practice of Auditing, Himalaya Publishing House, New Delhi
2. Pardeep Kumar, : Auditing - Theory and Practice, Kalyani
Jaswant Singh Publishing House, New Delhi

3. R. C. Bhatia : Auditing, Vikas Publishing House, New Delhi
4. S. D. Sharma : Auditing-Principles and Practice, Taxmann Publishing House, New Delhi
5. B. N. Tandon : Principles of Auditing, S. Chand Publishing House, New Delhi
6. Kamal Chopra : Contemporary Auditing, Tata McGraw Hill, New Delhi
7. T. R. Sharma : Auditing - Principles and Problems, Sahitya Bhawan, Agra
8. Dinkar Pagare : Principles and Practice of Auditing, Sultan Chand & Sons Publishing House, New Delhi
9. Jagdish Prakash : Auditing - Principles Practice and Problems, Kalyanai Publishing House, New Delhi

NOTE FOR PAPER SETTER

Equal weightage shall be given to all the units of the syllabus. The external paper shall be of the two sections viz, A & B.

Section - A : This section will contain four short answer questions selecting one from each unit. Each question carries 5 marks. A candidate is required to attempt all the four questions, Total Weightage to this section shall be 20 marks.

Section - B : This section will contain eight long answer questions of 15 marks each. Two questions with internal choice will be set from each unit. A candidate has to attempt any four questions selecting one from each unit. Total weightage to this section shall be 60 marks.

MODEL QUESTION PAPER

AUDITING

Max marks: -80

Time allowed: -3 hrs.

Section-A. (Marks 20) Attempt

all the four questions. Each question carries five marks.

1. Define Auditing. Point out its objectives.
2. Write short note on Internal Audit.
3. What is a voucher? Briefly explain its types.
4. Differentiate between clean & qualified report.

Section-B. (Marks 60)

Attempt any four questions selecting one question from each unit. Each question carries 15 marks.

1. Define auditing. Outline its principles.

OR

Write short note on importance of Auditing in Electronic Data Processing.

2. What are working papers? Explain their purpose & comment on ownership of working papers.

OR

Define Internal Control? Explain its characteristics.

3. Explain the Vouching of debit side of cash book.

OR

What is verification? Differentiate between vouching & verification.

4. Explain briefly the provisions regarding the appointment of an Auditor of a company.

OR

Explain the duties of a company Auditor.

INTRODUCTION TO AUDITING

- 1.1 Introduction
- 1.2 Objectives
- 1.3 Meaning of auditing
- 1.4 Objectives of auditing
- 1.5 Difference between
 - 1.5.1 Accountancy & Auditing
 - 1.5.2 Auditing & Investigation
- 1.6 AAS-I
- 1.7 Advantages & limitations of auditing
- 1.8 Conduct of audit
 - 1.8.1 Continuous audit,
 - 1.8.2 Periodical audit, interim audit
- 1.9 Auditing in electronic data processing (EDP) environment
 - 1.9.1 Meaning
 - 1.9.2 Problems
 - 1.9.3 Approaches
- 1.10 Summary
- 1.11 Glossary
- 1.12 Lesson end exercise
- 1.13 Suggested Readings

1.1 INTRODUCTION

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a bank to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors. If decisions are to be consistent with the intention of the decision makers, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and to the decision makers themselves. In the lending decision example, assume that the bank makes the loan on the basis of misleading financial statements and the borrower Company is ultimately unable to repay. As a result the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money. As society becomes more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, voluminous data and the existence of complex exchange transactions etc. As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits. A common way to obtain such reliable information is to have some type of verification (audit) performed by independent persons. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

1.2 OBJECTIVES

The objectives of this unit are :

- To develop understanding of meaning and objectives of auditing;
- To analyse difference between accountancy, auditing & investigation.

1.3 AUDITING : MEANING

The word audit has been derived from the Latin word ‘Audire’ which means to hear. Originally, whenever the owners of a business suspected fraud, they appointed certain persons to check the accounts. Such persons sent for the accountants and ‘heard’ whatever they had to say in connection with the accounts. The audit during those days was confined to ascertaining whether the accounting party had properly accounted for all receipts & payments on behalf of his principal and was in fact merely a cash audit. The object of modern audit has now expanded beyond cash verification to the verification of the financial position as disclosed by the Balance sheet and the Profit & loss Account of the undertaking.

An audit is an examination of the books of accounts and other records such as documents, vouchers etc. which confirm or support the correctness of the entries in the books of a business or concern to enable an auditor to satisfy himself as to whether the profit and loss account and the balance sheet exhibit a true and fair view of the state of the affairs of the concern, according to the best of the information and explanations given to him.

Definitions

‘Auditing is the examination of the books of accounts and vouchers of a business, as will enable the auditor to satisfy himself that the balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business, and whether the Profit and loss Account gives a true and fair view of profit or loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books, and if not, in what respect he is not satisfied’.

Spicer and Pegler

‘Auditing is the examination of a Balance sheet and Profit and Loss Account prepared by others, together with the books, accounts, and Vouchers relating to thereto in such a manner that the auditor may be able to satisfy himself and honestly report that in his opinion, such balance Sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of a particular concern, according to the information and explanations given to him, as shown by the books’.

F.R.M de Paula

‘Auditing is an examination of accounting records undertaken with a view to establish whether the records correctly and completely reflect the transactions to which they relate’.

L.R. Dicksee

‘Auditing is a systematic examination of the books and records of a business or other organisations, in order to ascertain or verify, and to report upon the facts regarding its financial operations and the results thereof’.

Montgomery

‘Auditing is concerned with the verification of accounting data, determining accuracy and liability of accounting statements and reports’.

R.K. Mouny

‘Auditing is a systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principles, management policies or stated requirements’.

Robert Schollosser

From the above definitions, it is clear that an auditor has not only to see the arithmetical accuracy of the books of accounts but has to go further and find out whether the transactions entered in the books of original entry are correct or not. Such things are possible only by inspecting, checking, reviewing and scrutinising the vouchers supporting the transactions in the books of account and examining the correspondence, minute book of the shareholders and directors, memorandum of association and articles of association, etc. Hence, it can be concluded that the audit means critical and intelligent examination of facts - financial or otherwise, to give in the form of certificate or report an attestation, an expert opinion or an expert advice.

1.4 OBJECTIVES OF AUDITING:

“The Auditing and Assurance Standards: Objectives and Scope of Audit of Financial Statements-AAS2” of the Institute of Chartered Accountants of India specifies that the objective of an audit is to express an opinion on financial statements. To give the opinion about the financial position, the auditor examines the financial statement to satisfy himself about the truth and fairness of financial position and operating results of the enterprise. The main object of the audit is always the establishment of the degree of reliability of the financial statements and produces a report on the organisations financial condition and working results. However, the detection of errors and irregularities and fraud is regarded as incidental to such main object.

In this light, the objectives of audit can be categorised into

- i) Main objectives
- ii) Secondary or subsidiary objectives and
- iii) Specific Objectives

I Main Objectives:

The main object of an audit is to verify and establish that at a given date balance-sheet portrays true and fair view of financial position of the business and the profit and loss account gives the true and fair view of profit or loss for the accounting period. It is to be established that accounts statements satisfy certain degree of reliability.

The auditor has to conduct an independent review of financial statements about their reliability, to form such an opinion, the auditor must examine the system of internal control and internal check, arithmetical accuracy of books of accounts, validity of transactions entered in the books and confirm the existence and value of assets and liabilities.

To judge the accuracy of the books of accounts, the auditor must:

- (a) Assess the system of internal control
- (b) Verify the accuracy of posting, balancing, etc.
- (c) Confirm the validity of transaction with supporting documents.
- (d) Ascertain whether distinction has been made between capital and revenue items
- (e) Confirm existence of assets and liabilities.
- (f) Ascertain all statutory requirements of maintenance of books and records.

II Secondary or Subsidiary objectives:

It follows that the examination of the books of accounts can be completed only if the audit reveal the errors and fraud in the books of accounts. Further, audit should prevent the re-occurrence of such errors and fraud.

The subsidiary objectives of audit are:

1. Detection and Prevention of errors.
2. Detection and Prevention of frauds

Detection and Prevention of Errors:

The object of the audit is to check errors. Errors are generally innocent but sometimes errors which might appear at first sight, as innocent are ultimately found to be due to fraudulent manipulation. Thus The auditor must check with care the cause of error. The errors may be divided into the following categories:

(1) Clerical errors

These errors generally arises or committed in posting, totalling and balancing, Such errors can be divided into (a) Error of Omission and (b) Error of Commission

(a) Error of Omission

When a transaction is left over completely or in the part being put in the book is called error of omission. As in the case of former, the omission is both on debit as well as credit sides, this does not affect the trail balance. This type of error can be detected by careful observation.. But if one aspect of a transaction has been entered in the books, it will affect the trial Balance& the omission will be easily detectable.

(b) Error of Commission

Such type of errors occurs when a transaction is recorded wrongly in the books of accounts. For example purchase worth Rs. 2500/- was entered in purchase book as Rs. 5200/- or the posting of Rs. 5000 to credit of Mr Rana instead of Mr Kana Vouching should be done carefully in order to detect such errors. Errors of commission includes wrong posting, carry forwards, totaling, balancing etc. Some of such errors can be detected by the non-agreement of the trial balance.

(2) Errors of Principle

This type of errors arise when transaction is being recorded in a fraudulently incorrect manner. Such type of errors may be wrong allocation of expenditure between capital and revenue, ignoring outstanding liabilities, wrong valuation of assets etc. Some errors of principle may affect the ultimate profit but may come from revenue items being posted to the wrong class of revenue account as an item of manufacturing. Such an error is not disclosed by the trial balance or by routine checking. It can be detected only by a searching inquiry and independent checking. Fictitious purchases may be recorded to misappropriate cash; actual sales may be shown as “goods on consignment” to misappropriate goods; good production may be sold as defective or as scrap and then may be used for personal purposes and so on. Business relies on the system of internal control to reduce the probability of occurrence of employee fraud. It can be detected only by a searching Inquiry & independent checking.

(3) Compensating errors or off setting errors.

It is one which is counter balanced by other errors or errors that is not known by the trial balance. If the original error and compensating error both arise in revenue account, the profit will not be affected by few entries in revenue account and other in assets or liabilities account, although the trial balance will agree the profit will be wrongly stated. Such errors arise in many ways but common in costing. These errors are most dangerous and are difficult to guard against. Such an error will not affect the trial balance and will not be detected easily. This error may or may not effect the profit & Loss Account.

(4) Errors of duplication

Entries are made in books of original entry more than once. The same transaction may have been recorded twice and also posted twice in the ledger. For example sales worth Rs.5000/- may be recorded twice in the accounts. They will not effect the agreement of trial balance. It becomes very difficult for the auditors to trace errors of this kind.

Location or detection of errors

Errors may arise at various stages in book keeping records. In general, such errors occur in the accounts innocently, but sometimes they are deliberately committed to cover some dishonest transactions. Some of the errors may be easily detected if they effect trial balance, while other may necessitate detailed checking for their detection.

The auditor should take the following devices to locate an error :

- (i) Scrutiny of books of accounts :** If the books are maintained on the self-balancing system, errors can be located with an exhaustive scrutiny of the books of accounts.
- (ii) Casting and tallying :** If the books are not maintained on the self-balancing system, the trial balance should be thoroughly checked and the casting of ledger accounts should be tallied with those given in the trial balance.
- (iii) Postings verification :** If necessary, books of original entry may be checked and postings into the ledger verified.
- (iv) Comparison of accounts :** The names of the accounts in the ledger should be compared with the names of accounts recorded in the trial balance. There are possibilities where some balances have not been carried forward to the trial balance.
- (v) Total and comparison :** The lists of debtors and creditors should be detected as if the various items given in the trial balance of the current year are tallied with those given in the trial balance pertaining to the previous year.
- (vi) Comparison of current and previous year :** Errors can also be located if the various items given in the trial balance of the current year are tallied with those given in the trial balance pertaining to the previous year.
- (vii) Careful checking :** The figures which appear to be doubtful and are struck off for some fraudulent purpose should be carefully checked.
- (viii) Carry forward techniques :** To check difference involving round figures, as 10,000 costs and carry-forwards should be examined and wrong totalling, if any, should be corrected. The difference in rupees and paisa should be traced through checking of posting and balancing of accounts.

- (ix) **Arithmetical Tools** : If the difference is divisible by two, it may be due to wrong posting or posting to the wrong side of an account in particular, e.g., a difference of Rs. 50 in the trial balance may be due to the posting of Rs. 25 to the debit side in place of the credit side of an account.
- (x) **Misplacement of figures** : Sometimes errors culminate due to misplacement or transaction of figures. Putting 45 for 54, 18 for 81, 27 for 72, etc., are some of such examples. Such a difference is due to misplacement of figures.
- (xi) **Careful and intensive examination** : After all, careful and intensive scrutiny is the only remedy for locating a particular error. The task is, in fact, tedious and arduous.

Detection and Prevention of Frauds

When something is done with an intention to deceive, to mislead or to conceal the truth, it is an art of fraud. It is false representation or entry which is made with some mischievous objectives intentionally to defraud certain persons. Frauds are more difficult to detect than unintentional errors. Detection of fraud is one of the principal functions of the auditors. Frauds may be divided into following categories :

1. Embezzlement or Misappropriation of cash,
2. Misappropriation of Goods,
3. Manipulation of Accounts

1. Embezzlement or Misappropriation of Cash : Misappropriation of cash is usually done by theft of cash receipts, petty cash, cheques, negotiable instruments, showing fictitious payments to workers, creditors, purchases etc. Misappropriation of cash is very easy. A person with a very little effort can misappropriate cash particularly in large scale business where contact between the owners of business and the person handling cash is not very close. Particularly when a persons is not subject to any form of check, such person has a number of opportunities and methods of committing frauds, but in a small business the possibility of such fraud remaining undetected is remote. But with the increase in size of business, the opportunities of committing fraud also increase because the owners of the business do not have direct control over receipts and payments of cash. The transactions relating to the receipt of cash are committed from the records or recorded with the lesser amount in cash book thereby all such cash or part of it is pocketed by the cashier. Similarly false payments of cash or over-payments of cash are shown in the cash book. A strict control system shall be adopted for receipts and payments of cash so that work of one clerk is automatically checked by another. This technique of audit is known as internal check. A number of examples of misappropriation of cash can be quoted :

- (i) Recording fictitious purchases and thereby cash involved therein is mis-appropriated.
- (ii) Omitting credit note received from the suppliers and discount allowed by them.
- (iii) Showing payment of wages to dummy workers in the wage sheet thereby mis-appropriating cash involved there in.
- (iv) Various receipts like bad debts, sale of scrap or rejected stock may be conceal.
- (v) Omitting the records of donation receipts by recording lower amounts on the counter foils of receipts book.

- (vi) The credit sales may not be recorded and money received from customers pocketed.
- (vii) Cash sales may not be recorded at all and money received there from may be misappropriated.
- (viii) ‘Teeming and Lading’ method may be adopted and when money received from a customer is pocketed and when later on money received from another customer may be shown as received from the former customer. This process may be continued for a long time till the fraud is detected.
- (ix) Cash received from sale or return or V.P.P. may be pocketed.
- (x) Certain false payments may be shown on credit side of cash book or excess amount of payments may be shown.

(2) Misappropriation of Goods : The misappropriation of goods is easy in case of those businesses which produce or deal in goods of high value and less bulky. Usually businessmen do not bother much for defalcation of goods as compared to mis-appropriation of money. This type of mis-appropriation is difficult to detect unless proper records are maintained. Defalcation of goods can be done by :

- (a) Issuing false notes to customers for sales returns and such goods are mis-appropriated.
- (b) Goods may be stolen by employees from the godowns.

It is not easy to detect mis-appropriation of goods. Only the efficient system of record-keeping, periodical checking, internal check and adequate security arrangements will be helpful to avoid misappropriation of goods. Where such systems are efficient and good, two or more persons must have committed such fraud, thereby it becomes more difficult to detect. Misappropriation of goods can be detected by thorough checking of records and physical verification of stocks as well as purchase and sales very carefully.

(3) Manipulation of Accounts : This type of fraud is committed by upper level of management with the different objectives to mislead certain parties within or outside the business. When ever such fraud is committed it usually involves large amounts and is intentional. This type of fraud is usually committed by managers, directors, board of directors etc.

Usually falsification of accounts is done without misappropriation of cash or goods. By making false entries in respect of expenses, sales, purchases, valuation of stocks etc. the business accounts are falsified which may not result in similar mis-appropriations.

Mainly, two types of motives are behind such manipulations :

(a) Showing Low Profits than the actual one

- (i) To give a wrong impression about success of the business to competitors.
- (ii) To reduce or avoid payment of income tax.
- (iii) To purchase shares at a lower price in the market.

b) Showing more profits than what actually they are :

- (i) The manager may get more commission if such commission is calculated on the basis of profits earned.
- (ii) To sell the shares at a high price in the market.

- (iii) The services of such person may be retained by showing more profits to the shareholders thereby the confidence of shareholders is maintained.
- (iv) To mislead financial institutions for obtaining further credit, the financial position of the business is shown better than what actually it is.
- (v) When the company is in the process of issuing shares to the public, to attract more subscribers for such shares.
- (vi) It may be done to show credit worthiness to creditors, bankers etc.
- (vii) High profits may be shown than what actually are to declare inflated rate of dividend.

Falsification of accounts may be resorted to by using the following devices :

- (i) Purchases or expenses may be inflated or suppressed :
- (ii) Sales or other incomes may be inflated or suppressed.
- (iii) Stocks may be over or under-valued.
- (iv) Omission of adjustment of expenses outstanding or prepaid expenses.
- (v) Depreciation on assets may be over or under charged or omitted altogether.
- (vi) Assets or liabilities may be over or under valued.
- (vii) Treating capital expenditure as revenue expenditure or vice-versa.
- (viii) Secret reserves may be created to deflate the profit or secret reserves of previous years may be used to inflate the profits with the knowledge of shareholders.
- (ix) Outstanding expenses of current year or prepaid incomes of previous year may not be adjusted to increase the profits.
- (x) Outstanding expenses of the previous year or prepaid incomes of current year may not be adjusted to inflate the profits of the current year.
- (ix) Window Dressing : The financial position of the business is shown in such a way that it seems better than what actually it is. Window dressing is more of representation than fraud.

It may be done in any of the following ways :

- (a) Purchases of current year may be shown as of next year.
- (b) Income of the previous year may be shown as of current year.
- (c) Expenses of current year may be shown as of next year.
- (d) Showing short term liabilities as long term liabilities.

- (f) Over-valuation of closing stock.
- (g) Over-valuation of assets or under-valuation of liabilities.

Position of Auditor in regard to Errors and Frauds Affecting Financial Statements

The auditor carries out necessary checks before expressing his opinion on the truth and fairness of financial position and operating results of an entity as reflected in financial statements. The auditor seeks to ensure that there is no material misstatement of financial information arising from errors or frauds. However, there is possibility that some material misstatement of financial information resulting from errors or frauds may creep in the financial statements. The misstatement may be subsequently found out. Can such subsequent discovery of the happening of errors or frauds point to the fact that the auditor has not performed his audit properly?

The auditor is an expert in his own field. He must have adequate expertise to testify the financial statements as to their truth and fairness. Definitely he must have at his disposal specialised skills to unravel the mess of errors and frauds. He is not to be merely written off as mere, “adder-upper and subtractor”. He must bring to bear upon in discharge of his duties such skill and diligence that he holds out to possess. He must, with utmost duty of care, skill of expertise and professional diligence, check the accounts to ensure that there is no material misstatement of financial information arising from errors or frauds.

But, it is to be remembered that there are certain limitations as to the audit. The auditor can not check every item of the financial transactions. He applies test checking of material items. The test nature of audit involves inherent risks associated with it. Secondly, the evidence he relies are only indicative and not conclusive in many of the cases. Thirdly, it is the responsibility of the management to introduce such in-built control system in the operational and accounting system as to reduce the chance of happening of errors or frauds. Even the management cannot completely eliminate the happening of errors or frauds; they can only reduce their occurrence. Fourthly, the management may, sometimes, flout its good conscience and make false representation to the auditor in respect of matters for which auditor has not other means of checking. Finally, frauds committed

with ingenuity is difficult to be detected with a limited period of audit checking. The instances like these hinder the auditor in his checking to detect errors or frauds that may affect the financial information materially.

Then what is expected of the auditor in such circumstance? The auditor is not expected to apply in his duty nothing more than reasonable skill and diligence to do the audit according to the generally accepted auditing practices. With necessary skill, diligence and care, if he expresses his opinion, he is relieved of any misstatement in financial information resulting from errors or frauds. What is the requisite degree of skill, care and diligence is a matter of specific factual circumstances of individual instances.

As observed by the learned judge in a famous Kingston Cotton Mills case (1896), the auditor is only a watchdog and not a blood hound. However, when there are circumstances arousing his suspicion, he must be doubly alert. He must so modify or enlarge his audit procedure and extent of checking to ascertain the truth. He must not recklessly leave unattended the grounds of suspicion when he encounters them. It was said in the judgement of the case Armitage Vs Brewer and Knott (1932). “That one piece of paper raised a grave suspicion. It was of critical importance. It was by little things like that forgeries and frauds were found out”. In the case State Street Trust Co. Vs Earnest (1938), it was said that the auditor is acting not properly if there is “a refusal to see the obvious, a failure to investigate doubtful, if sufficiently gross”.

The position of the auditor in regard to errors and frauds can be summarised as follows :

1. It is the responsibility of the management to prevent errors and frauds.
2. The auditor is not liable for any subsequent discovery of misstatement of financial information resulting from errors and frauds, he carried out his duty according to the generally accepted auditing practices.
3. If he discovers any errors or frauds during his audit, he must see that the errors are corrected and the effect of fraud on financial information of the financial statement is properly reflected. He must bring to the notice to the concerned, the occurrence of fraud at the earliest time.
4. The auditor need not sniff for errors and frauds. But, if he smells something about it, he should not leave them carelessly. He must enlarge his extent of checking and modify checking procedures to suit the occasion.

III Specific Objectives

The audit may encompass such areas like review of operations, performance management policy, cost records and so on. Accordingly there will be specific objectives in respect of each type of such specific audits. For example, in operational audit, the aim of audit is to evaluate the existing operations of the entity in order to give expert advice to improve their efficiency. Depending upon the nature of specific audit engagement and terms of engagement, there may be different objectives in respect of each specific audit.

1.5.1 Difference Between Accountancy & Auditing

In the earlier days, Book-keeping, Accountancy and Auditing were considered as the three aspects of the term Accountancy. This was the time when there was no demarcation between the duties of the book-keeper and the accountant. But with the increase in trade, commerce and industrial activities, book-keeping and accountancy have become separate functions. The following steps explain the distinction.

- | | |
|---------------------------|--|
| (a) Book-keeping | (i) Journalising |
| (Recording and Balancing) | (ii) Posting to ledger |
| | (iii) Totalling of various accounts in the ledger |
| (b) Accountancy | (iv) Balancing of ledger accounts. |
| (summary and Analysis) | (v) Rectification of errors |
| | (vi) Preparing the trial balance. |
| | (vii) Preparing Trading Profit and Loss Account. |
| (c) Auditing | (viii) Preparing Balance sheet |
| (Verification of Records) | (ix) Checking and verification of work done by Accountant. |

Book-keeping

Book-keeping is the art of recording day-to-day transactions systematically in the books of accounts. This part of the work is performed by the book-keeper. His job includes journaling, posting, totalling and balancing of ledger accounts. Whole of the work of book-keeper is mechanical involving use of principles of double entry system. A person with simple knowledge of double entry system can perform this job.

Accountancy

Work of accountancy starts where book-keeping ends. It is not wrong to say “Accountancy begins where Book-keeping ends”. The job of accountant starts when book-keeper has finished his job. The accountant has to satisfy himself that the transaction has been recorded and posted to the ledger properly. The work of accountant. is to check arithmetical accuracy of accounts prepared by book-keeper by preparing trial balance. If any error or omission arises it shall be rectified. Finally accountant has to prepare Trading Account, Profit and Loss Account and the Balance Sheet, incorporating necessary adjustments therein. It may be summed up that accountancy involves the following steps :

- (i) To check the work done by the book-keeper, to ensure that all the transactions have been recorded in the books of account.
- (ii) To prepare trial balance to ascertain that all the transactions are recorded properly and to make available balance of each account for preparing final account.
- (iii) To prepare Trading Profit and Loss Account indicating results of various transactions during the year and the Balance Sheet to indicate financial position at the end of the year.
- (iv) To make various adjustments in the books of accounts regarding the transactions and errors which are located after preparing the trial balance.
- (v) To design suitable accounting system to provide information as per the requirements of Companies Act, Sales Tax Act and Income Tax Act etc. and to protect business assets from unauthorised and improper use.

Auditing :

“Auditing begins where accountancy ends”. After the accountant has completed his work, an auditor is invited to verify the work done by accountant. It is not the duty of auditor to prepare the accounts. He is concerned with critical examination and verification of accounts prepared by others. Auditing presupposes the existence of completed financial statements prepared by the accountant. After completing his work, auditor has to submit a report of the fact whether or not profit and loss account and balance sheet exhibit true and fair position of the business.

An auditor must be competent person, well versed in various accounting systems and principles. As per the provisions of Companies Act he must be Chartered Accountant. Audit report must be prepared only after the auditor checked and verified thoroughly various accounting records.

An accountant cannot perform the function of an auditor. He can not certify that the financial statements are correct and present true and fair view. Auditing is always based on accountancy. There is a clear cut demarcation between the two.

Leach vs. Stocks Bros. & Pim (1937)

It was held that accountants were not negligent in preparing profit and loss account from the materials supplied to them and the instructions given specifically stated what they were to do.

It can be stated that it is not the part of accountant's duty to audit the accounts.

It is said, "Accounting is necessity whereas auditing is a luxury". This statement may be made from the view point of the following arguments.

- (i) Expenses and remuneration paid for the audit work is wastage of funds and thereby profits are reduced.
- (ii) During audit procedures, normal routine work is disrupted and there is wastage of time.
- (iii) With audit of accounts, there is no surity that all errors and frauds have been detected.
- (iv) It may look as unnecessary burden on the businessman as he has to observe a number of formalities.

The above arguments are baseless and do not have much relevance in context of benefits of auditing.

No doubt accounting is necessity but without auditing accounting statements do not find much recognition, so auditing is still more important. It may be in case of small business where accounts are maintained in crude form and control is exercised by the owners themselves, auditing may not be necessity or a legal requirement but still audit of accounts may provide valuable information regarding misappropriation, frauds etc. For every business, auditing of financial statements is of great importance. The audited statements having the stamp of professional qualified auditor are accepted by banks, income tax authorities and other financial institutions so it is wrong to say "auditing is luxury and accounting is necessity".

Accountancy vs. Auditing

The points of difference between Accountancy and Auditing can be as follows :

1. **Meaning** : Accountancy means maintaining the books of account whereas auditing means examining the accounts and reporting on their accuracy.
2. **Nature** : Accountancy is constructive in nature as it is concerned with compilation of accounting information for preparing Profit and Loss Account and Balance Sheet. Auditing is analytical in nature and is concerned with checking and verification of financial statements.
3. **Hierarchy** : The spade work is done by the accountant to enable the auditor to give a finishing touch. In other words "Accountancy begins where book-keeping ends and where accountancy ends, auditing begins? There can not be auditing without the prior existence of accounts.
4. **Scope** : The scope of accountancy is restricted to preparation of financial statements and their interpretation, whereas in case of auditing, it is determined by the agreement between auditor and his client.
5. **Purpose** : The main purpose of accountancy is to know the trading results or state of affairs of a business during a financial year, while the object of audit is to certify the correctness of financial statements prepared by the accountant.
6. **Qualification** : No prescribed qualifications are legally required to be possessed before appointment of an accountant is made but it is mandatory that an auditor of a joint stock company must be a Chartered Accountant.

7. **Reporting :** The accountant is not required to submit a report on the account and statements prepared by him. The auditor has to submit a report about correctness and presentation of accounts audited by him.
8. **Basis of Remuneration :** The accountant is paid monthly salary. The auditor gets a fixed amount as per agreement with his client.
9. **Replacement by Auditor :** An accountant is not expected to possess the knowledge of auditing but for an auditor it is quite necessary to have an in-depth knowledge of accountancy. In other words, an accountant cannot replace an auditor but he can be replaced by an auditor.
10. **Appointment :** The job of an accountant is generally entrusted to him by management and he is expected to perform the same whereas the auditor of a public company is appointed by the shareholders in the annual general meeting.
11. **Status :** An accountant is an employee of the firm whereas the auditor is an outsider who enjoys full autonomy.
12. **Duration :** The accountancy work is conducted throughout the year while the audit may be conducted at the end of the year or throughout the year.

1.5.2 Difference between Auditing & Investigation

Investigation means an inquiry into the accounts of a business for a special purpose. It is an examination of the books of accounts of a business to know its actual financial position or earning capacity, etc. Taylor and Perry have defined it as “Investigation involves inquiry into facts behind the books and accounts, into the technical, financial and the economic position of the business or organization”. It is a kind of special audit with a limited or extended scope according to the purpose for which it is conducted. Investigation is neither accountancy nor auditing.

Thus investigation is a kind of special audit with a limited or extended scope according to the purpose for which it is conducted. Investigation is neither accountancy nor auditing.

The main points of difference between audit and investigation are outlined as under:-

1. **Purpose:-** An audit is carried out for the purpose of expression of opinion on the financial statements of the business i.e. whether the balance sheet reveals the true and fair state of affairs of the business and the Profit and loss shows the correct profit or loss of the business; and to find out the correctness of the accounts, accuracy in recording of the transactions etc.

Investigation is conducted to ascertain facts required by the person for whom it is conducted. It is carried out for a special purpose. It aims at establishing a fact or assessing a particular situation.

2. **Coverage:** Audit of the books of accounts of an entity is normally conducted for the financial year or the accounting year.

Investigation may relate to several years or a small period or of a particular transaction.

3. **Approach:-** An auditor approaches his work without suspicion and foregone conclusion. He is a watchdog and not a blood hound. Audit is concerned with prime facie evidence.

Investigator always approaches his work with a suspicion, He possesses fairly a long nose to draw the foul smell. He looks for substantive and conclusive evidences.

4. **Mode:-** An auditor is concerned with the application of accounting principles, accounting system, conventions and procedures and scrupulously follows them. He is bound to execute his task according to the laws governing the business which he audits and professional ethics and conduct. He has to ensure that all disclosures are made in the financial statements.

The investigator is not bound by accounting conventions, policies and disclosure requirements. He examines the evidence in depth and goes far beyond the books of accounts in search of concrete evidence to arrive at a conclusion. He consider the depth of examination while verifying the books of accounts and records.

5. **Personnel:** Audit is to be conducted only by persons qualified to act as an ‘auditor’ under the Indian companies Act, 1956 and the Chartered Accountants Act., 1949. An investigation can be carried by any one person (individual) who is appointed for the purpose. No specific qualification is necessary.
6. **Necessity:-** Audit is compulsory in the case of Joint stock companies and other corporate houses. They have their accounts audited every year and a report is submitted to the shareholders and in certain cases to the Government. Similarly, firms and proprietary forms of organisations get their accounts audited every year for different purposes.

Investigation is not compulsory and is not carried out unless there is a need for it. There is no statutory obligation with regard to investigation.

However, the investigator and an auditor, try to locate acceptable evidence in support of their findings. They adopt the same technique such as statistical samplings; field enquiry, in depth examination etc.

1.6 BASIC PRINCIPLES GOVERNING AN AUDIT AS PER AUDIT & ASSURANCE STANDARD (AAS-I)

Basic Principles Governing an Audit: The Auditing and Assurance Standard 1 (SA200) on “Basic Principles Governing an Audit” issued by the Institute of Chartered Accountants of India describes the basic principles which govern the auditor’s professional responsibilities and which should be complied with whenever an audit of financial information of an entity is carried out. The basic principles as stated in this statement are:

- (i) **Integrity, Objectivity and Independence:** The auditor should be straightforward, honest and sincere in his approach to his professional work. 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 on being incompatible with integrity and objectivity.
- (ii) **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.
- (iii) **Skill 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.
- (iv) **Work Performed by Others:** When the auditor delegates work to assistants or uses work performed by other auditors and experts, he will be entitled to rely on work performed by

others provided he exercises adequate skill and care and is not aware of any reasons to believe that he should not have so relied. The auditor should carefully direct, supervise and review work delegated to assistants and obtain reasonable assurance that work performed by other auditors or experts is adequate for his purpose since he will continue to be responsible for forming and expressing his opinion on the financial information.

- (v) **Documentation:** The auditor should document matters which are important in providing evidence that the audit was carried in accordance with the basic principles.
- (vi) **Planning:** Planning enables the auditor to conduct an effective audit in an efficient and timely manner. Primarily, planning should be based on the knowledge of the client's business. Plans should be further developed and revised as necessary during the course of the audit.
- (vii) **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.
- (viii) **Accounting System and Internal Control:** 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 internal controls and evaluate the same to determine the nature, timing and extent of other audit procedures.
- (ix) **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 auditor should contain a clear written expression of 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. When a qualified opinion, adverse opinion or a disclaimer of opinion is to be given or reservation of opinion on any matters is to be made, the audit report should state the reasons therefore.

1.7 ADVANTAGES & LIMITATIONS OF AUDITING

Auditing refers to the periodic examination of accounts, documents and vouchers in a corporate world. This financial certainty will help the people understand the ascertained workplace. Here the vouchers and accounts cannot be fulfilled. Auditing will be done in both corporate and in public sector. It recognizes all the possible evidences that evaluates and formulates the opinion on the basis of communication that is carried out. Let us now look at few advantages and limitations of auditing.

Auditing is a best practice that ensures the growth of public companies. Many of the stakeholders of business are financial statements of the audit. Auditing is considered to be the place of substantive

testing and the need to be verified. It is considerable to follow the set of rules. It mentions maximum of the costs so that people can have prior intimation about the auditing. Here are some of the benefits of auditing. Some of them are listed below:

- a. ***Access to the capital market:*** Public has to remain under the security exchanges and the requirements given under it. Once the auditing is done the accounts that are audited are easily accepted by the Government such as Central banks, public authorities. This carries greater authority standards for the account to be authorized.
- b. ***Lower capital cost:*** This has reduced information that is associated with the financial statements that has lower interest rates and return on their investments. Sometimes this activity provides facilitated settlements and claims of a partner. By performing the process of auditing frauds and errors can be rectified on time.
- c. ***Deterrent to fraud and inefficiency:*** Auditing that has been carried out has to be within the claimed accounts department. In the event of loss, property that will maintain a fund is transferred. In case if the public has separate ownership plan then the claims has to be resolved from the insurance claims.
- d. ***Operational improvements:*** An independent auditor can be controlled and achieved operating efficiency within the client's organization. It has influence with the staffs along with the members of the client's organization.
- e. ***Ownership:*** If a public company deals with the audition they can try to reassure the stakeholders about the accounts that are maintained properly.
- f. ***Amalgamating members of the company:*** The nature of each organization will be to define the goals. This amalgamation helps in uniting people to work together as a team. This combination or unity can be found during the process of auditing.
- g. ***Value of business:*** The event of purchase has to be identified within the management and by the sales team. It is interrelated to the settlement of claims, retirement funds etc. In case of loss of property one has to enhance the activities with moral values.
- h. ***Gathering information about profit or loss:*** This gathering will help in discussing about the profit and loss of the company. Here employees can disclose their ideas upon which they are lacking and how can they overcome those obstacles.
- i. ***Confidentiality:*** During the process of external audit there are more private information such as internal employee salary, CPF etc. It may be significant for the person to learn about the organization. It is because the auditor makes the consideration and conducts the meetings that are to be held regarding audit.
- j. ***Assessing the tax:*** It is the process of calculating one's property. The person who calculates is called as assessor. This information will be recorded in local government regarding the taxes and support. It has a specialization in the preview logics that are specifically modified for the sake of insurance.
- k. ***Proof can be presented:*** During the audit one may collect the details from the person so as to ensure that every property has a legal proof. It helps in evaluation on further discussions. It helps in increasing the goodwill that might keep track of the collected data.

- l. ***Event of loss:*** In the event of loss of lives or property an individual can get help from the insured. It determines the values for business in the matter taking decisions on their own. It enables one to collect details about the accounts and properties that are maintained.
- m. ***Settlement of claims:*** Settlement of claims demands for the enhancement and better atmosphere that are sequenced within the organization. For accessing and to influence moral values one has to restrain themselves from performing fraudulent activities.
- n. ***Settlement of disputes:*** The disputes between the management can be settled easily that are handled within the past accounts. This requires independent information that is enhanced with the accurate assessment of the traders. It has more constructive way of improving the efficiency of business within the management.
- o. ***Reports:*** It produces the report of the truth and fairness of the reported audit. It involves financial statements that are more compatible when a person goes through the documents and reports of the audit.
- p. ***Maintaining reputation of the organization:*** At the course of completion of external audition, the reputation of the company is enhanced in the meanwhile ensuring the growth of the organization. It reviews the multitude of the regulations since, it maintains the reputation in the community.
- q. ***High quality perfection:*** Every organization will strive indefinitely for their success. These decisions will be taken incase to undertake the particular concept that an organization provides. These financial and representation of data can be gathered once the complete process of auditing gets over. It deals with the same accounting and interpreting of the high quality perfection.
- r. ***Ethical behavior:*** Auditing can be repeated to gain the business and its overall strategies. It devotes to the dealings in the world. This analysis and exceptions are the most ethical behavior of a company. This information about accounting and records are qualified under the procedures of the firm.
- s. ***Maximizing profit level:*** Audit is termed as an appraisal activity that is related to sequence of challenging circumstances that also involves the conflict that is pursued in the maximum profit level that is to be reached.
- t. ***Impairments with quality standards:*** Risk management here relates to the union and transactional specifications of the reviewed concepts. It has focused on the primary coordination of the standards. It must have impairments with the quality standards. This module is related to the estimates of expectancy. It avoids fraud activities that make use of the organization's resources. It is mainly related to the employee standards.
- u. ***Analytical procedures:*** It can neither help in prioritizing the changes and allocating them with the resources are recorded in the work papers of audits. It also involves control environment and appointment of analytical procedures of the system.
- v. ***Reconciliations of items:*** These findings will be identified if the reconciliations of the processed items and the respective operations are carried. This recommendation has to be finished atleast once in a month. The process of reviewing the reports can be estimated twice in a year.
- w. ***Accounting on auditing:*** Auditing is the process that includes testing and weighting of

the accounts. It is correctness of the reviews of the logics. It is critical, analytical and the investigation that is done leads to heavy work on ideas and adoptable methods. Audited accounts carry greater knowledge than the accounts that are under the process of auditing.

- x. **Returning the loan:** Some of the funds such as LIC, HUDCO, IFCI etc, evaluate the previous year auditing accounts that are determined are more reliable. One can take any kinds of loans that the bank offers. The policies that are followed does not remain constant whereas it will change twice in a year.
- y. **Provisions in budget:** Provision in budget results in the event of sales, profits, and business and sometimes account to loss. It also enhances the auditing even when the death of the partner is approved.
- z. **No politics:** Audits have politics that are no way related to politics or the politician. It has certain proves that acts the real linked data among the other recent ideas.
- aa. **Auditor constructive:** Constructive people make certain disputes and takes decision that re dictated free for the help and continues to report it. It works with the people those who deal with stakeholders to prove the efficiency in an organization. It forces the organization to force settle all the disputes. It helps in quick and common rectification of frauds and other common errors.
- ab. **Regular audit:** Regular audit deals with the accounts that are facilitated to involve the happening of the insured claims. It can create fear among the employees, so as to gain confidence about the related auditing sections.
- ac. **Settlement of claims:** Some of the audited accounts that are explained are defined and must fit into the claims so as to ensure about the recent files. It determines the value of business so as to claim for the purpose of the other networks.
- ad. **Money on contract basis:** Here the money involved is on contract basis that compromises certain related functions. It has the sense of hiring a permanent internal employee which makes more sense financially.

Limitations of Auditing

The main risk in audit program is towards the assurance services that derives wrong conclusions. Assurances are to be provided within the related certification. Here are some of the limitations of auditing.

- a. **Extra cost:** Testing involves extra cost to the organization which is considered as a burden. It involves the disruptions of multiple cases. The auditor has to concentrate more even though there are disruptions. Before audit begins the auditor must get the attention of all the staff members of the organization.
- b. **Evidences:** Evidences that are identified are more pervasive than conclusive. The strength of submission of audited accounts makes major changes in the accounts of distribution of profits.
- c. **Harassment of slaves:** Since the employees cannot express their own in terms of auditing, these changes are calibrated and the employees will feel harassed due to the changes that are caused. Even if they try to express their knowledge in new ideas, the organization may not entertain the employees in these types of situations.

- d. ***Unsuitable changes:*** The rules and regulations of business may vary from time to time. It remains unstable when the program begins. It is obvious that the company's policies may not change periodically whereas the rules and regulations may.
- e. ***Chances of fraud:*** Since the information delivered after audit procedure is credential then there becomes more chances of getting the situations where an individual will be forced to commit crime. It harasses the auditors to commit crime after the audit gets over.
- f. ***Small concerns:*** Small scale industries may usually proceed with transactions that are usually completed within the shorter period of time. Thus, auditing is not too important.
- g. ***Problems in remedial measures:*** Here the problem is created in remedial measures that are enhanced within the detailed interface of the data of remedial measures. These remedial measures are not included in the audit program.
- h. ***Insufficient considerate:*** The education curve will be contented about the business and insufficient relaxed networks and also offers systematic internal recruitment. These may gravely obstruct the expense of all the employees.
- i. ***Not guaranteed:*** Auditing cannot provide any data that are analyzed and prepared. It has financial accounts on the data that are provided. It is disclosed based on the information and explanations that are agreed by the clients.

Accuracy in the audit process plays a vital role that is reflected on the statement of correct amount. Classification of the transaction is handled properly and timings are recorded on the exact dates. Posting and summation of the master files amounts are properly classified. Therefore without audit process, progress of the company cannot be identified.

1.8 CONDUCT OF AUDIT

Audits help businesses uncover problems and ensure efficiency.

Here are the top 5 reasons to conduct an audit:

1. To ensure the effective operation of an organization.
2. To review compliance with a multitude of administrative regulations.
3. To instill a sense of confidence in management that the business is functioning well and you are prepared to meet potential challenges.
4. To maintain/enhance the organization's reputation in the community.
5. To perform a "due diligence" review for shareholders or potential investors. Not all policies, practices, and procedures are committed to writing. It is vitally important that companies have a process to ensure that everything stays up-to-date and legal, AND actually works as intended.

1.8.1 Continuous Audit

A continuous audit is one where the auditor is constantly engaged in checking the accounts during the whole period. The auditor visits his clients at regular or irregular intervals during the financial year

and checks each and every transaction. At the end of the year he checks the profit and loss account and the balance-sheet. A continuous audit is not of much use to small concern as its accounts can be audited at the end of financial year without much loss of time:

Definitions

“A continuous audit is one where the auditor, or his staff is constantly engaged in checking the accounts during the whole period or where the auditor, or his staff attends at regular or irregular intervals during the period.” *R.C. Williams.*

“A continuous audit involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole of trading”.
J.R. Batliboi

‘A continuous audit is one where auditor’s staff is occupied continuously on the accounts the whole year round or where the auditor attends at intervals fixed or otherwise, during the currency of the financial year and performs an interim audit. Such audits are adopted where work involved is considerable and have many points in their favour, although they are subject to certain disadvantages’.
Spicer and Pegler.

The following features of continuous audit come to light on analysis of the above definitions.

- a. It is carried throughout the year.
- b. It is conducted at regular or irregular intervals
- c. The accounts are subjected to scrutiny as and when prepared.
- d. Full verification of assets and liabilities is left until the balance sheet is prepared.
- e. Trial balance, profit and loss account and balance sheet are audited at the end of the year.

Business where Continuous Audit is Applicable:

1. Where it is desired to present the accounts just after the close of the financial year, as in the case of a banking company.
2. Where the volume of transaction is very large.
3. Where the statement of accounts is required to be presented to the management after every month or quarter.
4. Where no satisfactory system of internal check is in operation.

Advantages of Continuous Audit:

1. **Easy and Quick Discovery of Errors**
Errors and frauds can be discovered easily and quickly as the auditor checks the accounts at regular interval and in detail.

2. **Knowledge of Technical Details:**
Since the auditor remains more in touch with the business, he is in a position to know the technical details of it and hence can be of great help to his clients by making valuable suggestions.
3. **Quick Presentation of Accounts:**
Most of the checking work have been already performed during the course of the year, the final audited accounts can be presented to the shareholders soon after the close of the financial year at the annual general meeting.
4. **Keeps the Clients Staff Regular:**
As the auditor visits the clients at regular intervals, the clerks will be very regular in keeping the accounts up-to-date. They will see that there is no inaccuracy or frauds as it would be detected by the auditor at his next visit.
5. **Moral check on the clients staff:**
If the auditor pays surprise visits, it will have a considerable moral check on the clerks preparing the accounts as they do not know when the auditor may pay a visit to check the accounts.
6. **Efficient Audit:**
The auditor, having more time at his disposal, can check the accounts with greater attention and in detail and his work will be more efficient.
7. **Preparation of Interim Accounts:**
Where the directors of a Company wish to declare an interim dividend, continuous audit will help in the preparation of the interim accounts without much delay.
8. **Audit staff can be kept busy:**
The audit staff may be sent to other clients after having finished the work for one client. Thus, whole of the staff can be kept busy throughout the year :

Disadvantages of Continuous Audit:

In spite of the above mentioned advantages of a continuous audit there are certain drawbacks of such an audit which are as under :-

1. **Alteration of Figures :** Figures in the books of accounts which have already been checked by the auditor at his previous visit, may be altered by a dishonest clerk and the frauds may thus, be perpetrated.
2. **Dislocation of Clients Work:** The frequent visit by the auditor may dislocate the work of his client and cause inconvenience to the latter.
3. **Expensive :** It is an expensive system of audit.
4. **Queries may remain outstanding:** The audit clerk may lose the thread of his work and the queries which he wanted to make may remain outstanding as there might be a long interval between the two visits.
5. **Extensive note taking may be necessary in order to avoid any alteration in the figures after the audit.**
6. **Frequent visits by auditor may provide scope for unhealthy relationship between him and clerks.**

How to avoid short comings of continuous Audit

With the following precautions , shortcomings can be prevented

1. No alteration should be allowed to be made after the entries have been checked by the auditor, without his permission.
2. If any alteration has to be made, it should be done by means of a rectifying entry in the journal.
3. Checking of a book should be complete as far as possible at one visit to avoid loose ends. However, if this is not possible, the auditor should check the transactions upto a particular date and make a note of it in his diary and, if possible, he should make a note of the totals up to that date in his diary or note book and compare them at his next visit.
4. Well drawn-up programme by the auditor will prevent any loose ends.
5. A note should be made in the Audit Note Book regarding any queries which have not been satisfactorily answered. However, efforts should be made to get the matter settled rather than carry forward such queries the precise significance of which might be forgotten at a latter date.
6. If any alteration in a figure has already been made, the auditor should put a secret tick against such a figure. He may enter inset, in the coloured pencil, the correct figure or he may rewrite the correct figure in a different coloured ink and tick it as usual.
7. Before he begins his work, the auditor should glance over any alteration, which does not bear any secret tick.
8. The audit of Impersonal, General or Private Ledger should be conducted at the time of final audit as there is a greater possibility of fraud being committed by making fictitious entries in the nominal accounts which affect the personal accounts.
9. He should pay surprise visits so that the clerks of the client may not know the exact date of the visit of the auditor.

1.8.2 Annual Audit / Periodical Audit / Complete Audit :

Periodic audit is also called final audit. Under Periodical Audit the auditor takes up his work of audit only at the end of an accounting period. The auditor checks the financial transactions in continuous sessions or at one stretch.

According to De Paul, “Periodical audit is one where the auditor does not attend until the completion and closure of the financial accounts by the undertaking or client and the auditor takes the audit task as a whole and the checking is done at one time.”

Periodical audit begins when the accounting for the period ends. This form of audit is convenient for business houses which are not very big. Most of the Companies have their accounts audited under this system. In the case of periodical audit, the auditor will be in possession of all the books of accounts, vouchers and other documents related to the accounts.

Advantages of Periodical / Final Audit:

The following are the advantages of final audit :-

1. The auditor will have access to the books of accounts immediately after the close of the books. Once the records come to his hand, he can plan the whole work in such a way that there should be no possibility for alteration of any entry by the client's staff.
2. The cost of audit will be comparatively less.
3. The auditor can finish his work at few sittings and the time consumed will also be less.
4. The auditor can remember his observations well and will be in a position to write his audit report without any difficulty.
5. There is a little possibility for the auditor to collide, with the accounting staff and commit fraud etc.

Disadvantages of Periodical or Annual Audit

1. The audited accounts may not be available immediately after the close of the year. It may cause delay in the declaration of dividends and holding annual general meeting.
2. Auditor may not be able to check and verify all the transactions; there is every chance that some of the errors and frauds may be left undetected.
3. In big concerns, periodical audit is not very useful.
4. The auditor's report may get delayed. This can force the postponement of Annual General Meeting.
5. There is more dependence on the cooperation of management, which is not a desirable thing.

1.8.3 Interim Audit:

Meaning:-

Interim audit is one where the auditor conducts the audit for a part of the accounting year. It is an audit conducted at a particular date within the accounting period. The audit is carried out for specified purpose. Generally, large business houses, banks and life insurance corporations get their accounts audited at the end of every half year. This helps to determine the interim profits. It also helps to declare interim dividends.

Under interim audit the client will be in a position to understand the financial operations of the business and its results for the half year. The financial year i.e. the Budget may suitably be revised on the basis of the experience of the previous half year's business.

Advantages of Interim Audit:

The various advantages of Interim audit are as follow :-

1. The audit becomes easy and it can be completed without much lapse of time.

2. The client will know the financial operations for the half year and their results. He can therefore plan the working of the business on the basis of the results of the previous half year. There will be moral fear on the staff as the auditor will be in touch with business unit during the period of interim audit.
3. Errors and irregularities are found out earlier than in the system of final audit.
4. Interim audit helps to speed up the completion of final audit at the end of the financial period.
5. The audit will be more useful to have authenticated interim figures for publication.

Disadvantages of Interim Audit

1. Figures may be altered in the accounts which have already been audited.
2. It will mean that the audit staff will have to prepare notes when they finish the interim audit.
3. This mean additional work.

Continuous Audit V/s Interim Audit

1. In the case of continuous audit, the work of audit is carried on up to any date according to the convenience of the auditor and his client while in case of interim audit, the work of audit is up to a definite date according to the instructions of the client.
2. In the case of Continuous Audit, the verification of assets and liabilities is done after the balance sheet has been prepared at the end of the accounting period while in the case of interim audit the assets and liabilities are verified when such an audit is conducted.
3. In the case of continuous audit, no trial balance is prepared though the totals of certain accounts may be noted while in the case of Interim Audit the trial balance has to be prepared or checked.
4. In the case of Continuous Audit, the object is not to know profit or loss while the Interim Audit is conducted with the object of finding the profit or the loss.
5. In continuous audit, the auditor's report is submitted at the end of financial year, but in interim audit, it is submitted at the time of audit.

Internal Audit :

Meaning:

It implies the audit of accounts by the staff of the business. The staff may or may not have professional qualification for audit of accounts . The internal audit staff is permanent in nature and helps the business in early detection of errors and frands. The objectives and functions of internal audit depend on the nature of operations and business.

Some times the internal audit may be done by independent persons appointed for the purpose. "The Institute of Internal Auditors defines internal audit as below :-

“Internal auditing is the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as basis for protective and constructive service to the management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of control. It deals primarily with accounting and financial matters but it may also properly deal with the matters of an opening nature”. It is also covered with the verification and appraisal of the procedures and transactions.

The existence of internal audit is a help to the independent auditor. In certain matters the field of both is common. Both are interested in knowing whether an effective internal control system exists to prevent errors and frauds and whether accounting systems and procedures are adequate.

Advantages of Internal Audit:

Following are the advantages of internal audit :-

1. Service to management.
2. Provides assurance of an effective system of internal control that is not excessive.
3. Ensures a reliable basis for production of account and statements of trading.
4. Verifies the operation of established procedures and policies and sees that they are adequate, not wasteful.
5. Highlights departures from established procedures.
6. Draws attention to deficiencies in the system, control, practices etc.
7. Finds inefficiencies.
8. Suggests remedies and improvements.

Difference between continuous Audit and Periodical Audit. The main difference between continuous and Periodical Audit is as follow:

S.No	Continuous Audit	Periodical Audit
1.	The auditors staff visits and checks the accounts frequently	The auditors staff visits the business only once in a year after the accounts are closed.
2.	The clients’ staff becomes more efficient and regular.	It may not be so because client’s staff know that audit work will commence only after the close of the financial year.

3.	Continuous audit comes to an end with close of accounting period.	Periodical audit Commences after the accounts are closed.
4.	Immediately after the transaction is recorded, audit staff Checks and verifies it.	Audit staff Checks and Verifies the transaction after it is recorded.

1.9 AUDITING IN ELECTRONIC DATA PROCESSING (EDP) ENVIRONMENT

1.9.1 Meaning

EDP (Electronic Data Processing), an infrequently used term for what is today usually called “IS”(Information Services or systems) or “MIS” (Management Information Services or Systems), is the processing of data by a computer and its programs in an environment involving electroniccommunication. EDP evolved from “DP” (data processing), a term that was created when most computing input was physically put into the computer in punched card form and output as punched cards or paper reports.

Organizations have the challenge of dealing with employees’ honesty and trustworthiness. Auditing is used to circumvent any question of integrity. An electronic data processing audit is an evaluation of the accuracy and proper function of an organization’s data processing. Organizations mainly audit the accounting department. Other areas like project management, quality management and energy conservation are also audited. Auditing ensures compliance and checks on fraud of the company’s resources.

In an EDP (ELECTRONIC DATA PROCISSING) audit the auditor may not vouch each and every transaction but he must perform overall analytical checking to ensure that the financial records show true and fair view of the business entity.

Audit process in such a system may involve following steps:

Get Electronic Data

To commence the auditing process, auditors must first retrieve the data stored in the computer.

Documents such as sales receipts and supplies invoices are used to verify the data entered into the computer. This ensures that correct information was input into the computer.

Data Conversion

Organizations use different types of software to store their data. This data should be converted from the stored software to the auditing software. This is done using special software programs known as package and utility programs. This ensures that there is no inconsistency when auditing data stored in different software.

Compliance Test

Auditors need to verify that procedures followed when entering data into the data processing system are being applied as prescribed. These procedures act as the underlying evidence of whether the accounting data is correctly fed into the processing system. Obtaining this evidence involves reviewing the accounting journals, ledgers and worksheets. Compliance tests, which are tests used to verify the correct functioning of internal controls, are then carried out to indicate whether such internal controls are working properly. This provides the auditor with the overall picture of the truthfulness of data entered in the processing system.

Substantive Test

Auditors obtain evidence to verify the completeness, validity and accuracy of a client's records. This evidence is an important factor in determining the auditor's opinion on the records. Substantive tests in a merchandising firm would include examining inventory at the end of the period to verify that the levels of such inventory are as indicated in the records. An auditor can also request that suppliers confirm in writing the details of the debts owed by a firm at the end of the trading period.

Reporting

The main aim of an audit is to report to the client. A report should be written and signed after completing the audit examination; it also should include the auditor's opinion and the basis for it. The date of the report should also be included, along with recommendations for improvements of the entity's reporting system. Finally, reports should be objective, clear, concise and timely.

1.9.2 Problems

There are certain special problems of the edp audit which make it different from other manual audit which make it different from other manual audits. These are discussed in brief below:

i. Absence of audit trail :

In the computerized accounting and processing it is possible that there may not exist the proper working sequence that is available in a manual accounting system. As a result it may pose serious hindrance for the checking of the auditor. For example, in a manual accounting the purchase vouchers are first entered in the purchase book then the entries are posted to the ledger.

From ledger accounts the trail balance is made. Trial balance makes the base for the preparation of the profit and loss account and the balance sheet. In an edp accounting, the data may be available in the final stage only after being entered in to the system. An auditor may find only the end figure to verify, without getting the intermediary records. This makes his job of verification little difficult. Manipulations might have been done in the records that may be difficult to detect.

ii. Chances of manipulations :

The records kept on computer are more vulnerable to manipulations. Best were the days when the accounting was done in the bounded books. Any changes in such records were noticeable immediately. Neither the figures could be changed, nor could any pages of such records be removed.

Now in an edp accounting figures as well as pages could be changed with the stroke of a finger. Moreover such after changes are not visible at all. Therefore the auditor should be very careful while checking the computerized accounts. It should be kept in mind that it might contain manipulations.

iii. **Leakage of confidential information :**

It is very easy to copy delete or steal the records maintained on a computer. Any person who has an access to the computer can copy any important file or record within a fraction of a minute. The records kept on a computer should be properly guarded also.

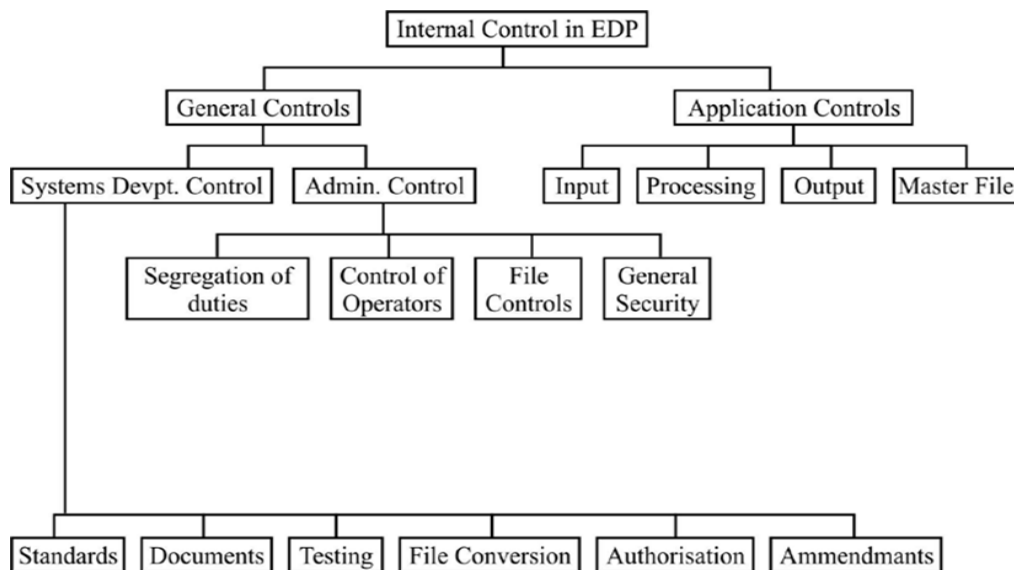
iv. **Computer virus and other failures:**

Records maintained on computer are prone to much distortion. The most important of such problems is the virus that can damage the whole data within no time. Computer and software breakdowns can damage the hard disc of the computer and as such the data may be lost permanently. Proper safeguard against such misshapeness' should be made. One solution for such problems is that proper backup of all the records be made and kept at a secure place.

1.9.3 Approaches

Internal controls in computer based accounting system are of two basic types:

- 1) General controls or organization controls
- 2) Application or procedural controls



General controls

This control covers the environment in which computer processing is conducted. Some of the objectives of general control include:

- a) To ensure adequate segregation of duties, that is, division of functional responsibilities
- b) To protect information contained in computer records etc. General controls can be subdivided into:

- i) Systems development and control
- ii) Administrative controls

i) **Systems development and control**

This covers the following areas:

Standards : There should be standard procedures to be followed anytime an application is introduced. This will include adequate feasibility studies covering investigation, fact recording and analysis of gathered facts. It also covers the design of new systems, implementation and most importantly systems change over procedure.

Documentation: There should be proper documentation using flow charts, decision tables, structured English etc and all these should be incorporated in a manual for use.

Testing: The new system should be fully tested before being used operationally. Programs should be checked with test and live data while the whole system should be tested using parallel running or pilot operation technique.

File conversion: Before the new system becomes operational, master files should be set up completely and accurately. This can be achieved by a complete print out of the contents of master files and crosschecking the results with manually maintained records. This process is referred to as conversion checks.

Authorization: Each system development stage should be reviewed by a responsible officer in the EDP department and it must be approved by the steering committee or board of directors but most importantly, it must be acceptable to user department.

Amendment Changes to operational system or programs should be subjected to the same controls as initial development. It must be authorized and controlled.

Conclusion. It is important to consult with auditors because they would want to ensure that sufficient control is present in the new system to maintain reliable accounting records.

ii) **Administrative Controls**

This includes:

a) **Division or segregation of duties:** Data processing staff should not initiate transactions or authorize normal transactions while users should not operate the computer by self to process transactions. In modern system, this division is not practicable since some authorization function is implicitly transferred to computers. For example, a computer raising purchase requisition when stock reaches re-order levels. Also, the main functions within the data processing department should be carried out by separate persons. Only user department staff and data processing department staff should be allowed to amend input data while computer operators should have access to the machines during a processing run.

However, small companies may be constrained by inadequate human and financial resources which must be balanced with increased supervision by responsible officers.

b) **Control over computer operators.** There should be control over computer operators using manual with details of standard procedures to be followed always. There should be frequent and independent review of computer usage by references to clerical and machine logs. There should be rotation of operators' duty and a minimum of two operators per shift.

c) **File control**

This will cover:

- i) **File storage procedure:** This involves the use of locks and keys on computer files and programs. These devices should be kept in a conducive atmospheric environment. A record of file usage should be maintained and ensure its prompt returns.
 - ii) **File identification procedures:** Which includes physical label by allocating unique identification no to the file which can be manually checked.
 - iii) Protection rings or written permit rings for magnetic tapes or disc files must be physically attached before any processing. Machine labels using header and trailer labels such as file name, identification number, retention period will be checked by a computer programmer on set up.
 - iv) **File reconstruction procedures:** This involves recreation when contents of computer files are lost, stolen or damaged. This can be achieved by retention of earlier generation of master file and related transaction data's file such as Grand father, father son technique for magnetic tapes, dumping or copying for magnetic disc or diskette.
- d) **General security:** There should be restriction of access to computer facilities by beating the equipment in a room with locks. Camera facilities may also be employed. Standby arrangements such as power generating plants supplemented by uninterrupted power supply (UPS) should be provided for. Maintenance agreement should be signed with the computer vendor. Adequate insurance policy should be obtained to cover risk of fire, flood etc.

Application or procedural control:

This includes:

Input, processing, output and master file controls. These controls are to ensure the completeness and accurate processing of data.

- a) **Input controls:** There should be segregation of duties between users and EDP functionals. For example, input should be originated by users only, and amendments should be done by authorized personnel.

There should be segregation of duties between punching and verification when converting input into machine sensible form. There should be physical control over source documents (such as vouchers, sales invoices) input media (such as magnetic tapes, disc and diskettes). There should be procedures for recording investigating errors and resubmission for processing. Batch control (such as control total, batch total and hash or nonsense total) to be used in order to achieve completeness and accurate processing. Control total involves counting the number of documents in a batch for control purposes .If this count is found to be incorrect at a later stage in the system, the batch can then be checked to find out what has gone wrong.

Batch total involves choosing a quantitative field and accumulating its value together for control purposes. Examples of quantitative fields are : total values of invoices, total value of overtime

payments, total quantity sold etc. Harsh total involves choosing a field which has no quantitative meaning and accumulating its value together. Examples are: totals of invoice numbers, customer numbers, payroll numbers etc the total of which are meaningless but useful for control purpose; thus, the term or name harsh or nonsense total.

Also, validation checks or data vet or edit control can be built or programmed into input conversion to validate input for reasonableness. Examples are types or data vet or field or character check, limit or range check, existence check, reasonableness check, sequence check, completeness check.

Processing control

This relates to all arithmetic and logic operations or input carried out by programmed procedures such as edit controls or data vet.

Check digit verification

A check digit is a number which is added to a series of reference numbers for the purpose of producing a self checking number. Each check digit is derived mathematically and bears a unique mathematical relationship to the number to which it is attached. When the reference number is input into the system, the validation programme performs the same calculation and the resultant remainder should be zero. If not then the reference number is incorrect. The objective of the check digit verification is to prevent transposition and transcription errors.

Field|Characteristics|type|format|presence check

Under this, data is checked to ensure that all necessary fields are present and that the fields contain the correct type of characteristics; that is there are no letters in a numeric field.

Limit or range check

Numbers are checked to ensure that they are within the permissible range or limit and any data outside these limits will be rejected.

Completeness check

This includes control, batch and nonsense totals.

Sequence check

This is to check sequence failure and duplicate records

Screen check

This involves operators' scrutiny before the data is processed by the computers. It also involves pre-formatting of screen to minimize operator error.

Existence check

This involves testing reference numbers with previously established list of valid numbers held on a computer file or in the programme in order to ensure that only valid general ledger codes are input.

Reasonableness check

This is to check whether the data is reasonable in relation to a standard or previous input. Examples are hours worked, interest rate, units of utility consumed and prices of goods received.

Output control

There should be reconciliation or matching of input totals established prior to processing to computer generated output totals. There should be manual checking through on a sample basis of the basic calculations carried out by the computer such as depreciation charges, direct debit etc. There should be a procedure for distributing output, that is, a list of authorized recipients should be maintained. An output register should be used to monitor distribution and confirm receipts. These should be independent review of exception reports.

Master file controls

There should be proper control over input, processing and output amendment. That is, once written; standing data or stable data should remain unaltered until an authorized change is made. There should be periodic print out of standing data (such as customer's name & address, standard and overtime rates, employee name and location etc) For checking with manually held information. There should

be regular print out of individual balances such as debtors, creditors etc for comparison with customer statement of account.

Computer assisted audit techniques (CAATs)

Computer Assisted Audit Techniques (CAATS) or Computer Aided Audit Tools or Computer Assisted Audit Tools and Techniques (also sometimes referred to as CAATTs) are becoming more popular. Now more than ever before, these tools are being used throughout the industry to assist internal auditors in their search for irregularities in data files, to help internal accounting departments with more detailed analysis and to support the forensic accountant with extrapolating large amounts of data for further analysis and fraud detection.

Simply put, CAATS are used to simplify or automate the data analysis process. Although CAATs have been around for years, accountants are finding it easier to use these techniques now to analyze large volumes of data for anomalies. And with advances in technology, it is simpler to obtain data files and have access to many of the improved tools on the market.

The average accountant no longer needs to know how to do computer programming to be able to identify, request and import the data for analysis. The accountant simply needs to be in a position to select the appropriate data files and then rely upon core skills to perform specific tests on that data.

Selecting the appropriate data file may sometimes be a little tricky. Generally, a meeting with the client, the client's internal or external technology personnel and the addition of a Certified Information Technology Professional (CITP) credential holder to your audit team can definitely help with the appropriate data file identification process.

Once you obtain the appropriate data files and import them into your CAATS tool, it is time for the analytics. Many of the tools on the market today include automated routines that perform common queries. In addition to the "included" routines, CAATS user groups are pretty common and can be found all over the Internet. Also, don't forget about the power of the Social Networking sites. Joining one or

more of these user groups and/or participating in a shared interest community on a social networking site, will give you access to thousands of routines created and posted by fellow user group members.

Once a routine is created for your specific situation, the same routine can be run generally from year to year without investing any additional up-front time. Data file structures and audit procedures generally tend not vary much from year to year. Therefore, when links have been established between the routine and the data file, the task can be assign the subsequent year to less experienced members of the audit team.

There are two broad categories of CAAT:

1. Audit software; and
2. Test data.

Audit software

Audit software is used to interrogate a client's system. It can be either packaged, off-the-shelf software or it can be purpose written to work on a client's system. The main advantage of these programs is that they can be used to scrutinise large volumes of data, which it would be inefficient to do manually. The programs can then present the results so that they can be investigated further.

Specific procedures they can perform include:

- Extracting samples according to specified criteria, such as:
 - Random;
 - Over a certain amount;
 - Below a certain amount;
 - At certain dates.
- Calculating ratios and select indicators that fail to meet certain pre-defined criteria (i.e. benchmarking);
- Check arithmetical accuracy (for example additions);
- Preparing reports (budget vs actual);
- Stratification of data (such as invoices by customer or age);
- Produce letters to send out to customers and suppliers; and
- Tracing transactions through the computerised system.

These procedures can simplify the auditor's task by selecting samples for testing, identifying risk areas and by performing certain substantive procedures. The software does not, however, replace the need for the auditor's own procedures.

Test data

Test data involves the auditor submitting ‘dummy’ data into the client’s system to ensure that the system correctly processes it and that it prevents or detects and corrects misstatements. The objective of this is to test the operation of application controls within the system.

To be successful test data should include both data with errors built into it and data without errors. Examples of errors include:

- codes that do not exist, e.g. customer, supplier and employee;
- transactions above pre-determined limits, e.g. salaries above contracted amounts, credit above limits agreed with customer;
- invoices with arithmetical errors; and
- submitting data with incorrect batch control totals.
Data maybe processed during a normal operational cycle (‘live’ test data) or during a special run at a point in time outside the normal operational cycle (‘dead’ test data). Both has their advantages and disadvantages:
- Live tests could interfere with the operation of the system or corrupt master files/standing data;
- Dead testing avoids this scenario but only gives assurance that the system works when not operating live. This may not be reflective of the strains the system is put under in normal conditions.

Advantages of CAATs

CAATs allow the auditor to:

- Independently access the data stored on a computer system without dependence on the client;
- Test the reliability of client software, i.e. the IT application controls (the results of which can then be used to assess control risk and design further audit procedures);
- Increase the accuracy of audit tests; and
- Perform audit tests more efficiently, which in the long-term will result in a more cost effective audit.

Disadvantages of CAATs

- CAATs can be expensive and time consuming to set up, the software must either be purchased or designed (in which case specialist IT staff will be needed);
- Client permission and cooperation may be difficult to obtain;
- Potential incompatibility with the client’s computer system;
- The audit team may not have sufficient IT skills and knowledge to create the complex data extracts and programming required;

- The audit team may not have the knowledge or training needed to understand the results of the CAATs; and
- Data may be corrupted or lost during the application of CAATs.

Other techniques

There are other forms of CAAT that are becoming increasingly common as computer technology develops, although the cost and sophistication involved currently limits their use to the larger accountancy firms with greater resources. These include:

Integrated test facilities - this involves the creation of dummy ledgers and records to which test data can be sent. This enables more frequent and efficient test data procedures to be performed live and the information can simply be ignored by the client when printing out their internal records; and

Embedded audit software - this requires a purpose written audit program to be embedded into the client's accounting system. The program will be designed to perform certain tasks (similar to audit software) with the advantage that it can be turned on and off at the auditor's wish throughout the accounting year. This will allow the auditor to gather information on certain transactions (perhaps material ones) for later testing and will also identify peculiarities that require attention during the final audit.

1.10 SUMMARY

Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

The term auditing has been distinguished from accounting and investigation. The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and result of operation of the organisation. Investigation is undertaken for some special purpose i.e. to determine the extent of fraud or to determine the purchase price of the organisation and the like.

Objectives of audit are broadly classified into a) primary objective and b) secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the secondary objective is to detect and prevent errors and frauds. A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, statements of various types of claims, securing loans from banks and other financial institutions, etc.

Audit is classified into various types, viz., audit under statute, audit of accounts of private firm, audit of accounts of private individuals, audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, viz. continuous audit or periodical audit or interim audit. Besides being a Chartered Accountant an auditor should possess certain other qualities, such as knowledge of relevant laws, intelligence, tactfulness, vigilance, honesty and integrity, courage, impartiality, broadmindedness, patience, perseverance, maintaining secrecy of his client, commonsense etc.

1.11 GLOSSARY

- **Auditing:** Auditing is a systematic and scientific examination of the books of accounts and records of business to enable the auditor to satisfy himself that the profit and loss account and the balance sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.
- **Continuous audit:** An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.
- **Errors:** Mistakes committed innocently and unknowingly while making entries in the books of accounts.
- **Frauds:** Fictitious entries made in the books of accounts with certain motives.
- **Interim audit:** An audit which is conducted for a part of the accounting period for some specific purpose.
- **Investigation:** Examination of accounts for special purpose.
- **Qualified auditor:** A person who is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949.
- **Statutory audit:** An audit undertaken under any specific statute or Act.
- **True and fair view:** A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e. the financial statements must not contain errors and fraud.
- **EDP :** electronic data processing
- **CAATS:** Computer Assisted Audit Techniques

1.12 LESSON END EXERCISES

1. “An auditor is a watch dog and not a bloodhound “Discuss.
2. “Accounting is a necessity while auditing is a luxury for a business.” Explain.
3. ‘Auditing begins where accountancy ends “. Comment.
4. “Continuous audit is a double edged sword “. Discuss.
5. Explain Audit approach in an EDP environment.\

1.13 SUGGESTED READINGS

1. Contemporary Auditing : Kamal Gupta, Tata Mc-Graw Hill, New Delhi.
2. A Hand-Book of Practical Auditing: B.N. Tandon, S.Chand and Company, New Delhi.
3. Fundamentals of Auditing : Kamal Gupta and Ashok Arora, Tata McGraw Hill, New Delhi.

**AUDIT PLANNING, INTERNAL CONTROL
INTERNAL CHECK AND INTERNAL AUDIT**

- 2.1 Introduction
- 2.2 Objectives
- 2.3 Steps to be taken before commencement of an audit
- 2.4 Audit Programme
 - 2.4.1 Advantages of Audit Programme
 - 2.4.2 Disadvantages of Audit Programme
- 2.5 Working Papers
 - 2.5.1 Purpose of Working Papers
 - 2.5.2 Classification of Working Papers
 - 2.5.3 Form & Content of Auditing Working Papers
 - 2.5.4 Ownership of Auditing Working Papers
- 2.6 Internal Control
- 2.7 Internal Check
- 2.8 Internal Audit
- 2.9 Distinction between Internal Check & Internal Audit
- 2.10 Summary
- 2.11 Lesson End Exercise
- 2.12 Suggested Readings

2.1 INTRODUCTION

Internal control is a broad term with a wide coverage. It covers the spectrum of control of the whole Management system. The control may be financial and/or non financial. It means internal control involves a number of checks & control exercised in a business to ensure its efficient & economic working. It aids the organization to meet & realize its own goals more effectively & efficiently. To the auditor, it extends a basis of reliance for the audit procedures to be undertaken.

2.2 OBJECTIVES

After reading this unit, you should be able to

- Explain the meaning of audit programme;
- Understand the purpose for auditing working papers;
- analyze the contents and ownership of working papers & also elucidate the meaning of audit evidence;
- Distinguish between various kinds of audit evidence;
- Describe the method of collecting audit evidence.
- develop understanding of meaning, characteristics of Internal control;
- know the meaning, objectives and principles of internal check;

2.3 STEPS TO BE TAKEN BEFORE COMMENCEMENT OF AN AUDIT

Before beginning the audit work, an auditor must review the various arrangements with his client to decide his future course of action, usually, the following points must be considered in this connection.

1. **Ascertain the scope of duties:** The auditor should ascertain the scope of his duties and responsibilities from statutes, or from the instructions received from those employing his services. If he is appointed under any statute, his duties and responsibilities are enumerated under it and cannot be contracted. However, they may be increased by an agreement between the client and the auditor. The auditor's duties and responsibilities are determined by reference to terms of agreement entered into between him and his client, who may be partners in a firm, or a sole trader. He has no statutory obligation to comply with. He has only to carry out the instructions he receives from his clients.
2. **Procure Engagement Letter:** When auditor decides to accept an audit engagement, he should procure an Engagement Letter from the client. The letter for audit purposes an audit contract. It should lay down terms of the audit contract and the understanding reached between the auditor and the client. The letter may be a standard letter engaging an auditor for audit of the accounts prepared in accordance with established accounting practices. In case, the auditor is to perform special assignment or tasks, the same should be included in the Engagement Letter or Audit Contract. Such a letter or contract is highly desirable to avoid any misunderstanding with the client. The letter will also prove to be handy, if he is accused of not performing the work promised by him.

3. **Period to be covered:** The auditor should ascertain the period to be covered in the audit. Usually the period is one year, but the period may be more or less than one year if conducted for specific purposes.
4. **Use of client's staff:** The auditor may have his own staff or may take the assistance of his client's staff where some clerical work is also to be performed. He should know whether he can use the client's staff as per agreement or not.
5. **Place of Audit Work:** The auditor should know the place of his work. This place is where he will open his office with his staff and conduct his enquiries. Regarding working conditions proper arrangement must be made with the client as it is in the interest of effective conduct of his audit work.
6. **Review of Business:** This includes the review of the following:

(i) **Nature of Business:** The auditor should know the precise nature of his client's business, its technicalities, etc. In the case of the audit of accounts of a manufacturing concern he should go around the factory, as it would help him see and appreciate the nature of transactions that are recorded in the books, and he will have a rough idea about the process, the nature of machinery, materials and men involved etc. This acquaintance will enable him to acquire grasp of affairs and appreciate the essentials.

(ii) **Organisation of Business:** The auditor should know the organisation of the business human as well as physical, with the help of organisation charts, work flow charts, the chart of accounts, the list of officials, the authority and responsibility of the persons with whom he has to deal during the conduct of audit.

In order to have a clear idea of the physical organisation, the auditor should go around the plant and other physical conditions. Knowledge of the physical conditions, such as the locating of the purchase department, the sale department, the material handling store, etc. help the auditor in establishing his audit procedures and methods.

(iii) **Basic Documents of the Business:** The auditor should study the legal documents governing the concern, such as the partnership deed in the case of a partnership, the memorandum and articles of association in the case of company, any contracts with vendors and other special acts in the case of government company, the will or settlement in the case of trust. The auditor should note the clauses that are likely to affect the accounts.

(iv) **Accounting Frame works:** A study of the opening trial balance of previous year's accounts and financial statements, trends of rates, and the accounting policy will assist the auditor in determining the scope of his examination if the audit is a repeat engagement. For this purpose the auditor should study the following:

(a) **Previous Accounting Records and Balance Sheets:** In case the accounts of the business have been audited previously, the auditor will get a good background of financial history of the organisation by studying the accounts and balance sheet for previous years. He should note the comments and suggestions of the previous auditors on the accounting system. He may study some of the items of trial balance to ascertain whether the accounting principles have been followed to value stock-in-trade from year to year, so that costs of sales figures are comparable.

- (b) **Additional Accounting Work:** If the client has done some additional accounting work the auditor should go through it. For example he should know if the client has calculated accounting ratios and trends etc., as this will help him in planning his audit work. The comparison of ratios and trends may indicate some variations or unusual fluctuations on which the auditor should focus his attention.
- (c) **Basic Accounting Policies:** Though there are well established principles in accountancy, the accountants sometimes apply varying postulates according to their own judgements. These affect the audit work, hence the auditor should know the accounting policies of his client.
- (d) **Various Control systems:** After review of accounting frameworks the auditor should thoroughly investigate the entire system of book-keeping and internal control in force in the organisation. The auditor should consider carefully the whole system in order to decide what ground his audit should and to what extent he may rely in internal control. In the words of Paula and Paul, 'If this investigation is to be done effectively it must be done systematically, and the best modern practice is to complete an internal control questionnaire. This document contains a series of questions that the auditor should ask, the replies being sufficiently detailed to give a comprehensive record of the accounting system, showing the effectiveness of the internal checks. When completing the questionnaire the auditor must not accept casual explanations. He must make detailed inquiries, inspect records and wherever possible observe the procedures in operation. During subsequent audit work he must satisfy himself that checks are in fact carried out, and make any revisions necessary to the questionnaire to keep it continually up-to-date'.

(7) **Classification:** The auditor should clear the following points with the client :

- (i) the confirmation of receivable;
 - (ii) the time of starting the examination;
 - (iii) fees to be charged;
 - (iv) the preparation of tax returns;
- (i) whether or not the client's records are to be closed prior to the start of the examinations.

If the audit is a repeat engagement, work papers and correspondence of prior years should be reviewed.

2.4 AUDIT PROGRAMME

Proper implementation of any plan depends upon a good programme. Even a computer gives a good solution, if it is provided with correct and sound programme. Therefore, auditor should chalk out a programme according to the requirement of each case as to what work is to be done by senior or junior staff and the time by which the work is to be finished. While preparing audit programme, the auditor must keep in mind the size and composition of the organisation and nature and extent of internal control. Audit programme are generally prepared in columns form providing information regarding the name of clerk doing the work, the type of work, its date of commencement

and completion. Every audit assistant signs the audit work performed by him so that he owns the responsibility of the same.

Audit programme are generally prepared with the columns provided for the name of the clerk doing the work, the type of the work, the dates when he started and finished the work. It will also enable the auditor to find out the extent of work completed and to be completed.

Each audit assistant signs for the work he has performed so that the responsibility may rest upon him for the work he has done. The audit programme must contain a list in detail of the steps to be performed in the course of verification and examination of the books of accounts. It should also state the nature and extent of examination, the time to be consumed or required for work details regarding the assignment of duties among senior and junior auditors and clerks, the safeguards or protection to be taken to avoid omissions and duplications in work, and the arrangement needed for the audit work. The auditor while drawing the programme should also keep in mind the possibilities for changes in the basic programme that will be drawn by him and allow for modification of the plan of work. The programme should be such that it should take into account the nature and character of the business as well as the current requirements of law governing the business in the matter of audit. Thus, the audit programme is to be flexible giving room for the junior auditors to use their initiative in the audit work. The programme should not become a routine. An effective programme could be drawn through discussion with audit staff and after proper enquiry, observation and study of the client's system of accounting and the reliability that can be placed on the internal control measures in existence in the business unit.

2.4.1 Advantages of Audit Programme

Some of the important advantages of conducting an audit programme according to pre-determined audit programme are:

- i.** Audit programme is prepared to know exactly the responsibility of every clerk in the auditor's staff. Thus, each one of them gets work according to his capacity.
- ii.** The auditor can know about the progress of the work done by his staff.
- iii.** Since the programme takes into consideration all the details involved in the work to be followed during audit, no portion of the work is left from checking.
- iv.** It increases the efficiency of his staff as in that case, possibility of errors and negligence is minimised.
- v.** Another advantage that follows, is that in case, a clerk goes on leave, the portion of the work where he has left can easily be located and assigned to another clerk.
- vi.** The auditor can produce it as an evidence to prove against the charges of negligence leveled against him as the programme is a proof to justify and show that a particular work has already been done by him.
- vii.** It provides a sort of guidance to ensure that the whole work of audit has been properly distributed and nothing has been omitted.
- viii.** The work of audit can be done smoothly with uniformity and the auditor can proceed well with the same set of programme in subsequent audits.
- ix.** Before signing the report, it is easily possible for the auditor to have the final review of the work done by him. At this stage, it may be explored whether everything has been completed or not.

- x. It provides a clue to prepare a plan of action for the years to come.
- xi. With the help of audit programme, the work of audit can be completed in time quite methodically and efficiently.
- xii. The audit programme after completion of work becomes a sort of progress chart and the auditor can easily find out that the work has been completed as per his plan and with its help, he can confidently proceed to sign the final audit report.

2.4.2 Disadvantages of Audit Programme

There are, however, certain disadvantages of such an audit programme which are mentioned below:

- i. An efficient clerk loses his initiative because he has to adhere to the programme fixed for him. He may not make any suggestion.
- ii. Even if the audit programme is well drawn up, it may not cover many things that might come up during the course of audit.
- iii. The audit programme may be followed mechanically year after year though some routine changes might have been introduced by the client. As a matter of fact, the audit programme for each new audit should be an improvement over the previous year according to experience.
- iv. Each business may have a separate problem of its own and hence, a rigid programme cannot be laid down for each type of business.
- v. Drawing up of an audit programme may be unnecessary for a small concern.
- vi. The audit clerk may regard the work entrusted to him according to the programme as the maximum work to be done by him.
- vii. The staff of the client can form an idea about the trend of audit after having seen the audit functioning from year to year.

To overcome these disadvantages an auditor should impress upon his staff that the programme suggests the basis upon which the audit is to be conducted and they must keep in mind the objectives of an audit. Execution of audit programme should not become an objective in itself; surprise checking outside the predetermined audit programme will also help in minimizing the impact of disadvantages. The auditor should not depend entirely on one standard audit programme; he should receive suggestions from the audit staff and review the audit programme from time to time in the light of variation of nature of business or management.

2.5 WORKING PAPERS

Working papers refer to the papers prepared by auditor for audit work as well as the documents, statements and recorded information obtained by the auditor from his client and other connected with the business. The Institute of Chartered Accountants of England and Wales refer to the usefulness of working papers in planning the audit and audit work. The working papers to be prepared and maintained by the auditor relate to the circumstances of audit. The term 'Working

papers' encompasses 'The file of analysis, summaries, comments and correspondence built up by him during the course of field work of an audit engagement'.

According to the Institute of Chartered Accountants of India, working papers must include audit programme, queries, explanations given for the queries, schedules of important items like depreciation, inventories, confirmation from third parties, certificates issued by the management, banks etc.

The working papers provide basic evidence of the audit conducted in accordance with standard audit practices. They help the auditor in writing the report. The quality of audit work performed by the auditor can be judged by the character and contents of working papers prepared and maintained by the auditor.

2.5.1 Purpose of Working Papers

Working papers should be carefully prepared as they are the basis of conclusions and summations shown by the auditor in the report. As such they should be clear, complete and contain all essential information with regard to accounts and audit so that they may be of maximum utility. Each completed work paper should be signed and dated by the persons performing the work. This will help in fixing responsibilities. They should be properly organized and arranged so that one may not find difficulty in pinpointing a particular matter, it has been rightly said, 'An auditor is often judged- and quite properly so- by the character of the working paper prepared by him or under his direction'.

The various objectives of working papers are as follow:

- i.** In order to support the auditor's report these show in detail the work performed by the audit clerks.
- ii.** The auditor can form an opinion about the efficiency or otherwise of the audit clerks.
- iii.** As the working papers remain with the auditor, they are the permanent records and, therefore, in case of any suit against him for negligence, he can defend himself on the basis of these working papers.
- iv.** The preparation of the working papers is a mean to give training to the audit clerks as to how to summarize the work done by them.
- v.** The working papers enable the auditor to point out to the client the weakness of the internal control system in operation, and inefficiency of the accountancy system. He may, therefore, be in a position to advise his client as to how to avoid such pitfalls.
- vi.** The working papers help the auditor to plan for the succeeding year.
- vii.** The working papers enable the auditor to prepare the report to be issued without much waste of time.
- viii.** He can know that his assistants had followed his instructions.
- ix.** If changes and transfer of staff are very frequent and in case such working papers exist the audit work can be assigned to others with minimum of dislocation with least possibility of duplication and omission of any work.

- x. Future audit work can be carried on in the same sequence on the basis of the previous working papers.
- xi. Items left outstanding during the previous year, e.g. any document not produced, may be paid particular attention in the future.

2.5.2 Classification of Working Papers

Working papers can be classified into three categories

- Permanent file papers
- Audit administrative papers, and

Audit evidence papers.

1. Permanent File Papers- The permanent file contains papers of continuing interest over many years' audits of the same client. The file can be used year after year. It is a ready source of information for the first time familiarization with the client for the staff for the audit. The matters contained shall be suitably enclosed. These should normally include:

- (a) Memorandum and articles of association and other statutory documents (e.g. partnership deed). Copies of other documents and minutes of the meetings having a continuing importance.
- (b) A short description of the type of business carried on and places of business.
- (c) List of account records and responsible officials and plan of organisation.
- (d) Statements showing a note of any accounting matters of importance e.g., the policy regarding valuation of inventories, policy regarding charge of depreciation.
- (e) The clients internal accounting instructions and internal audit instructions or stock staking instruction.
- (f) Copies of continuing contracts.
- (g) A brief history of the company, its products, markets.
- (h) Copies of balance sheets of earlier years.

It is important to ensure that the permanent file is brought up to date at appropriate time;

2. Audit Administrative Papers (Current File) - Administrative records contain the fruit of early planning phases of the audit. Usually these papers are bound together with the current year's audit evidence papers. All the work done in the course of audit planning, assignment of staff, evaluation of internal control and audit programme preparation is a part of audit administration and is documented in the working papers.

Generally, the following items may appear in the print of each year's current file:

1. Appointment letter
2. Memoranda of meetings with management.
3. Memoranda of meetings with the audit committee of the client.
4. Memoranda of review notes and unfinished procedures.
5. Audit time budget.
6. Internal control questionnaire.
7. Management control questionnaire.
8. EDP control questionnaire.
9. Internal control systems and flow charts.
10. Audit programme.
11. A working trial balance of general ledger accounts.
12. Working paper record of preliminary adjusting and reclassifying entries.

3. Audit Evidence Papers- The current year evidence working papers contain the record of the procedures followed, the tests performed, the evidence obtained and the decisions made in the course of audit. These papers themselves are communications of the quality of audit. Therefore, these must be clear, concise, complete, well-indexed and informative. Each separate working paper must be complete, so that this may be removed from the working paper file and considered on its own. Paper cross-references should be available to show, how the paper coordinates with other working papers.

The most important aspect of the current audit evidence papers is the requirement that they show the auditor's decision problems and their conclusions. Thus, the papers must record the audit issues being addressed or the problems being probed, the evidence gathered for the purpose and the final decision. These records can take many forms - numerical, narrative or pictorial. The form will depend upon the decision problem. The circumstances and type of report rendered.

2.5.3 Form and Content of Auditing Working Papers

Statement on standard Auditing practices-3 (sap-3) issued by the institute of chartered Accountants of India in July 1985 makes the following suggestions regarding the form and contents of working papers:-

1. The working papers should record the audit plan, the nature, timing and extent of auditing procedures performed and the conclusions drawn from the evidence obtained.
2. The exact form and contents of working papers are affected by various matters like:-

- (a) The nature of the engagement.
 - (b) The form of the audit report.
 - (c) The nature and complexity of client business.
 - (d) The nature and condition of the client's records and degree of reliance on internal controls.
 - (e) The need in particular circumstances for direction, supervision and review of work performed by assistants.
3. Working papers should be designed and properly organised to meet the circumstances of each audit and the auditors need in respect thereof. The standardisation of working papers (e.g. check lists, specimen letters, and 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 mean to control its quality.
 4. Working papers should be sufficiently completed and detailed for an auditor to obtain an overall understanding of the audit.
 5. All significant matters which require the exercise of judgement, together with the auditor's conclusion thereon, should be included in the auditors working papers.
 6. To improve audit efficiency, the auditor normally obtains and utilises schedules, analyses and other working papers prepared by the client such as analysis of important revenue accounts receivables etc. The auditor should satisfy himself that such working papers have been properly prepared.
 7. In the case of recurring audits, some working papers may be classified as permanent audit files as distinct from current audit files relating primarily to the audit of a single period.

2.5.4 Ownership of Auditing Working Papers

An important and pertinent question arises as to who is the owner of these working papers. The claim of the auditor is that it is he who has collected the information for the purpose of discharging his duties, therefore he is entitled to the possession of these papers. On the other hand client claims that since auditor is his agent he should surrender these papers to him as every other agent does. The auditor argues that in case he is charged by his client of negligence, he can produce these papers as an evidence in his defence. Therefore, he wants to retain the possession of this important evidence with him. He also contends that as a professional etiquette a retiring or outgoing auditor should hand over these papers to new appointee, to enable him to plan his future work. However, the controversy has been settled in the light of two important English Judgements namely.

Sockockinsky vs. Bright Gramh & Co. (1938) and *Chantrey Martin & Co. vs. Martin (1953)*. In the first case it was held that the working papers belonged to the auditor because they were independent contractors and not agents of the clients. In the second case it was held that the working papers prepared by the accountant for the sole purpose of producing a balance sheet belonged to the accountant and not to the client. The court opined that where the accountant merely acted as agents of the clients like in the case of correspondence between accountant and income tax authorities, the papers belong to the client and not to the accountant.

On the basis of these judgements it can be said that generally, an auditor as an independent professional is entitled to the working papers prepared by him. However, wherever he corresponds with any third party as an agent of the client, the papers rightfully belong to the principal. But, where an auditor has not been paid his fees, he can retain such papers as he has a right of particular lien upon the books of account and other documents.

According to the views of the Institute of Chartered Accountants of India (SAP-3), 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. Further, in the opinion of the Institute an auditor should adopt reasonable procedures for the 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.

2.5.5 Essentials of Good Auditing Working Papers

The essentials of good working papers are as under:

- a) Papers should contain all necessary information so that they may be of maximum use. Facts which are of no importance should be left.
- b) The working paper should be so arranged that one may not find any difficulty in locating a particular subject. If they are not properly arranged, the work of making report might be delayed besides waste of time.
- c) The facts in the working paper should set out clearly so as to be self-explanatory.
- d) There should not be any room for confusion. The facts state should be readily apartment to the reader later on.
- e) Papers used for writing papers should be of good quality.
- f) Paper used should be of uniform size.

2.6 INTERNAL CONTROL

It involves various methods and procedures, adopted in an organisation with a view to safeguard its assets, to ensure that the accounting and statistical data produced are reliable and accurate; to promote greater efficiency in operation; and to carry out effectively general policies as laid down by the management. It is to be recognised that the major issues in relation to control are fast developing. It involves even keeping the administrator posted with the up-to-date information which reflects the result of policy and which would also provide a sound basis for ascertaining the future course of action.

“Internal control, as defined in accounting and auditing, is a process for assuring achievement of an organization’s objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. A broad concept, internal control involves everything that controls risks to an organization” From Wikipedia, the free encyclopedia

It is a means by which an organization’s resources are directed, monitored, and measured. It plays an important role in detecting and preventing fraud and protecting the organization’s resources, both physical (e.g., machinery and property) and intangible (e.g., reputation or intellectual property such as trademarks).

At the organizational level, internal control objectives relate to the reliability of financial reporting, timely feedback on the achievement of operational or strategic goals, and compliance with laws and regulations. At the specific transaction level, internal control refers to the actions taken to achieve a specific objective (e.g., how to ensure the organization's payments to third parties are for valid services rendered.) Internal control procedures reduce process variation, leading to more predictable outcomes.

'Internal control has long been recognised as fundamental and indispensable to modern auditing. The recognition emerged gradually in the early days of the profession as auditors sought to explain the practical discovery that, for most purposes, an examination of every transaction was seldom necessary. In recent years, understanding of internal control and its relationship to auditing has depended, in part as a result of the advances in cybernetics and in the technology of control made by management scientists and computer specialists.

Montgomery

The scope of internal control, according to this definition, extends beyond accounting controls and includes all operational controls like quality control, work standards, budgetary control, periodic reporting, internal checks, internal audit, policy appraisals, quantitative control etc. Thus, it undoubtedly, consists of many aspects related to control in the organisation.

'Internal control is best regarded as the whole system of controls, financial and otherwise established by the mgt in the conduct of a business including internal check internal audit and other forms of control'. **Spicer and Peglar**

According to **Water B. Meigs**, 'A system of internal control consists of measures employed by a business for the purpose of':

- Safeguarding its resources against waste, fraud and inefficiency,
- Promoting accuracy and reliability in accounting and operating data,
- Encouraging and measuring compliance with company's policy, and
- Judging the efficiency of operations in all divisions of the business.

2.6.1 Objectives

Internal controls are a system's capability to prevent or detect material data processing errors or fraud and provide for correction on a timely basis. Common internal controls include segregation of accounting & operations duties, two signatures on every check, 2 approvals on any requisitions, etc. The objectives of Internal controls are as follows:

1) Optimize use of Company Resources

- Prevent unnecessary duplication and waste
- Possible conflict between safeguarding of assets and providing reliable information and optimizing use of resources

2) **Prevent and detecting error and fraud**

3) **Safeguard company's assets**

- Adequate controls necessary to prevent theft, misuse or accidents

4) **Maintain reliable control systems**

- Necessary to produce accurate information to carry out operations
- Information must be timely and reliable

More specifically Management needs to ensure the following:

- Validity** – recorded transactions are valid and documented (purchases are supported by purchase orders, receiving documents, and invoices)
- Completeness** – all valid transactions are recorded and none are omitted (all receiving documents are matched to purchase orders)
- Authorization** – transactions are authorized according to company policy (purchases greater than \$500 must be signed off by department head)
- Accuracy** – transaction dollar amounts are properly calculated (receipts of inventory are correctly recorded in the accounting system)
- Classification** – transactions are properly classified in accounts (purchases of assets are correctly capitalized and amortized, purchases of inventory are correctly recorded as inventory)
- Accounting** – transaction accounting is complete (all purchase orders are captured in the system, are matched to receiving documents and invoices as the goods are received)
- Proper period** – transactions are recorded in the proper period (goods that have been received and there is no invoice yet received are accrued for at year end)

2.6.2 Characteristics of Internal Control

Following are the features of internal control:

- i. That all transactions are carried out with specific sanction and authorisation of the management.
- ii. The transactions are accounted in the related books of accounts, regularly, correctly and systematically according to the accounting policies and procedures.
- iii. There is complete accountability for all assets.
- iv. Use and access towards assets are made only with proper authorisation.
- v. There is periodical verification and comparison of assets in existence with accounting

records, and appropriate action is taken with regard to any difference.

- vi. That adequate accounting system appropriate to size and nature of business is in existence.
- vii. Specific internal control procedures could be designed to achieve the aforesaid activities. That could include:
 - (a) Checking the arithmetical accuracy of the records.
 - (b) Maintenance of reconciliations.
 - (c) Auditing of routine, control accounts and trial balances.
 - (d) Approval and control of documents.
 - (e) Comparison with external sources of information.
 - (f) Comparing the results of cash, security and inventories with accounting records.
 - (g) Limiting direct access to assets.
 - (h) Comparison of results with budget.

Internal control and Auditor:

The introduction of a well-developed system of internal control is the responsibility of the management. But it is a matter of concern for the auditor though he has no authority to recommend and prescribe that certain rules and procedures should be adopted by the business. He can simply guide and help if he is required to do so. What is expected from him is that he must possess an expert's knowledge of such procedures. In the second standard of field work set out by the AICPA, it is made clear, "there is a proper study and evaluation of the existing internal control as a basis pro-reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." Thus, the aim behind the study of internal control by an auditor is to establish a basis for reliance on the system of this control so as to enable him to assess the extent to which he should apply tests during the course of audit.

This is much certain that if there is a good system of internal control, the work of an auditor becomes quite easy. He can very conveniently rely on test checking. However, it depends upon special circumstances of a particular case as to how far internal control would be helpful in the audit work. The following points would be helpful in screening the internal control system:

- i. Study of accounting routine, its weakness and sources from which they would arise.
- ii. Financial power vested in the various officials and the circumstances in which they are to be used.
- iii. Study of limits of inspection over financial and other accounting duties.
- iv. Whether some mechanical appliances are used to prevent any defalcation of cash, etc., and

- v. Whether any device of checks and balances is used to measure the success of accounting methods or techniques.

The auditor can be in a position to perform audit efficiently provided that there is a good and effective internal control system in use. However, it does not mean that he can take shelter under the system and shirk to his duties. The entire responsibility is his and there is nothing to protect him if he does his work carelessly and with negligence. An auditor is mainly concerned with the evaluation of the internal control system in force so that he may be able to know-

1. Whether mistakes, errors and frauds are likely to be located in the ordinary course of operation of the business.
2. Whether an effective internal auditing department exists or not.
3. How far and how adequately the management is discharging its functioning so far as correct recording of transactions is concerned.
4. How extensive examination should be carried out in the different areas of accounting?
5. How far administrative control has a bearing on his work?
6. What should be the appropriate audit programme in existing circumstances?
7. To what extent reliability can be placed on the reports, records and the certificates of the management?
8. Whether some suggestions can be given to improve the existing internal control system.

2.6.3 Importance of Internal Control

Before introducing a proper system of internal control, the businessman must know the object or purposes for which it is to be introduced. The objectives of internal control or the need for evaluation of internal control can be studied in two phases:

A. From Client's Point of View

Cost benefit analysis is applied by the management to assess and select a particular method of control and its applicability to the business conditions. The benefits which the internal control system offers are:

- (i) **Providing reliable data:** Business decisions require accurate information to run the business activities efficiently. Examples of significant areas where management requires reliable information are fixation of selling prices, production directives depending on requirements etc.
- (ii) **Safeguarding assets and records:** The physical of a company can be stolen, misused or accidentally destroyed, if not properly protected by adequate controls. The same is true of non physical assets such as accounts receivable the important e.g: confidential government contracts and records. (e. g) the general ledger and journals). The safeguarding of certain assets and records has become increasingly important since the advent of computer system. Large amounts of information stored on computer media such as magnetic tape can be destroyed permanently if care is not taken to protect them.

- (iii) **To promote operational efficiency:** the controls within an organisation are meant to prevent unnecessary duplication of efforts protect against waste in all aspects of the business and discourage other types of inefficient use of resources.
- (iv) **To encourage adherence to prescribed policies:** The system of internal control is meant to provide reasonable assurance that procedures and rules of the various are followed by company personnel.

(B) From the Auditor's Point of View

The study and evaluation of the client's systems of internal control is important to auditors. The auditor must have a thorough understanding of the system. A bird's eye-view of the controls fails to meet the standard of due care. There is a difference between the system that is supposed to be in operation and the one actually being used. Simply by asking certain questions, reviewing of the organisation chart and studying a few procedure manuals to obtain an understanding of the system is not sufficient. No doubt these are important parts of reviewing, but to obtain an adequate understanding; the systems must also be tested.

There are two ways in which the study and evaluation of the clients systems of internal control is used:

- (i) To determine whether an audit is possible; if possible, then
- (ii) To determine the scope of audit.

2.6.4 Auditors Duty as regard Internal Control

The internal auditors and external auditors of the organization also measure the effectiveness of internal control through their efforts. They assess whether the controls are properly designed, implemented and working effectively, and make recommendations on how to improve internal control. They may also review Information technology controls, which relate to the IT systems of the organization. There are laws and regulations on internal control related to financial reporting in a number of jurisdictions. In the U.S. these regulations are specifically established by Sections 404 and 302 of the Sarbanes-Oxley Act. Guidance on auditing these controls is specified in PCAOB *Auditing Standard No. 5* and SEC guidance, further discussed in SOX 404 top-down risk assessment. To provide reasonable assurance that internal controls involved in the financial reporting process are effective, they are tested by the external auditor (the organization's public accountants), who are required to opine on the internal controls of the company and the reliability of its financial reporting.

Audit committee

The role and the responsibilities of the audit committee, in general terms, are to: (a) Discuss with management, internal and external auditors and major stakeholders the quality and adequacy of the organization's internal controls system and risk management process, and their effectiveness and outcomes, and meet regularly and privately with the Director of Internal Audit; (b) Review and discuss with management and the external auditors and approve the audited financial statements of the organization and make a recommendation regarding inclusion of those financial statements in any public filing. Also review with management and the independent auditor the effect of regulatory and accounting initiatives as well as off-balance sheet issues in the organization's financial statements;

(c) Review and discuss with management the types of information to be disclosed and the types of presentations to be made with respect to the Company's earning press release and financial information

and earnings guidance provided to analysts and rating agencies; (d) Confirm the scope of audits to be performed by the external and internal auditors, monitor progress and review results and review fees and expenses. Review significant findings or unsatisfactory internal audit reports, or audit problems or difficulties encountered by the external independent auditor. Monitor management's response to all audit findings; (e) Manage complaints concerning accounting, internal accounting controls or auditing matters; (f) Receive regular reports from the Chief Executive Officer, Chief Financial Officer and the Company's other Control Committees regarding deficiencies in the design or operation of internal controls and any fraud that involves management or other employees with a significant role in internal controls; and (g) Support management in resolving conflicts of interest. Monitor the adequacy of the organization's internal controls and ensure that all fraud cases are acted upon.

Personnel benefits committee

The role and the responsibilities of the personnel benefits, in general terms, are to: (a) Approve and oversee administration of the Company's Executive Compensation Program; (b) Review and approve specific compensation matters for the Chief Executive Officer, Chief Operating Officer (if applicable), Chief Financial Officer, General Counsel, Senior Human Resources Officer, Treasurer, Director, Corporate Relations and Management, and Company Directors; (c) Review, as appropriate, any changes to compensation matters for the officers listed above with the Board; and (d) Review and monitor all human-resource related performance and compliance activities and reports, including the performance management system. They also ensure that benefit-related performance measures are properly used by the management of the organization.

Operating staff

All staff members should be responsible for reporting problems of operations, monitoring and improving their performance, and monitoring non-compliance with the corporate policies and various professional codes, or violations of policies, standards, practices and procedures. Their particular responsibilities should be documented in their individual personnel files. In performance management activities they take part in all compliance and performance data collection and processing activities as they are part of various organizational units and may also be responsible for various compliance and operational-related activities of the organization.

Staff and junior managers may be involved in evaluating the controls within their own organizational unit using a control self-assessment.

2.6.5 Limitations of Internal Control

Standard auditing practice -6 issued the institute of chartered accountants of India highlights certain inherent limitations of internal control system. these include the following:

- a) Operation of the internal control system involves expenditure of time and money. Management's consideration that a control should be costs effective weakness the effectiveness of the internal control systems.
- b) Internal controls are concerned more the transactions of a routine nature: so unusual and irregular transactions may be overlooked by the internal control system.
- c) The possibility for human error may weaken the internal control system.
- d) Possible collusion between persons operating the internal control and the employees of the client- enterprises or outside parties may render the controls ineffective.

- e) The possibility that a person responsible for exercising control could abuse his authority.
- f) The possibility that changes in conditions may be render the procedures ineffective and in adequate compliance with the procedures may deteriorate the system.
- g) Manipulation by the management may defeat the objectives of internal control.

Evaluation of Internal Controls:

The auditor has to examine and find out as to how far the internal control system is adequate, effective and reliable. Such an evaluation of the internal control in the organisation will help the auditor to plan and draw his programme of audit work. The evaluation of internal control is recognised as a part of the standard audit procedure.

The Indian Companies's Act sec. 227 (4-A) requires the statutory auditor to comment specifically on internal control in his report on the business. Hence, the auditor has to evaluate the internal control system of a company incorporated under the act so that he could comment on the system in existence. An auditor can review and evaluate the effectiveness and reliability of the internal control system of a business through various ways:-

1. Enquire the managerial personnel at various organisational levels about the controls in existence and discuss their effectiveness.
2. Refer the procedural manual (Accounting-manuals, office-hand books, job charts, flow-charts) and find out the functional responsibilities, pathways of work and controls.
3. Select few transactions and trace them through the accounting system and internal control.
4. Enquire as to the existence and continuance of internal control system throughout the accounting period of the year under audit.
5. Collect and record information on internal control system through questionnaires, flow-charts and analysis of records and narrative description.
6. Apply compliance procedures to identify the effective functioning of controls throughout the period of intended reliance.

2.7 MEANING OF INTERNAL CHECK

The term 'Internal Check' implies the organisation of the system of accounts of an office or factory and an arrangement by which the duties of the various members of the staff of a business are allocated in such a way that the work done by one person is automatically checked by another, so that frauds cannot be committed only by collusion between two or more employees and errors or irregularities are quickly discovered. The main objective of internal check is to prevent and alternatively make early detection of frauds, errors, wastes and misappropriation.

In order to understand clearly the meaning of internal checks, let us go through some important definitions which are as follows:

'Internal Check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently checked by other member of the staff'.

‘Such an arrangement of the book keeping routine that errors and frauds are automatically prevented or discovered by the very operation of the book keeping itself’.

L.R. Dicksee

‘Internal check is a system or method introduced with defined instructions given to staff as to their sphere of work with a view to control and verification of their work and also maintenance of accurate records as the ultimate aim’.

D.R. Davar

In sum, the whole system of accounting needs to be organized in such a manner that it may ensure some sort of check without incurring additional financial burden. To meet this end, the method of internal check has been devised. It is an arrangement of the duties of members of staff in such a manner that the work performed by one person is automatically and independently checked by another.

2.7.1 Objectives of Internal Check

The objects of internal check system are to minimize the chances for the commission of errors or fraud; to enhance the efficiency of the employees; to avoid any omission of any transaction from being recorded.

The main objectives of internal check are as under:

- i. To exercise moral pressure over staff.
- ii. To ensure that the accounting system produces reliable and adequate information.
- iii. To provide protection to the resources of the business against fraud, carelessness and inefficiency.
- iv. To distribute the work in such a manner that no business transaction is left unrecorded.
- v. To allocate duties and responsibilities of each clerk in such a way that he may be held responsible for particular fraud or error.
- vi. To minimise the chances of errors, frauds or irregularities in the business.
- vii. To increase the efficiency of clerks because the allocation of duties is based on the Principle of division of labour.
- viii. To detect errors and frauds easily if it is committed, because in an efficient internal check system, there is a provision for independent checking.

2.7.2 Principles of Internal Check

The various principles of internal check system are as follows:

- i. **Responsibility:** Responsibility of each individual must be properly defined and fixed. The work of the business should be allocated amongst various clerks in such that their duties and responsibilities are clearly divided.

- ii. **Completion:** The work should be divided in such a way that no single person is allowed to complete the work solely by himself from the beginning to the end. However, there should be no duplication of work.
- iii. **Rotation of employees:** A good system of internal check should not allow persons having custody of assets to have access to the books of accounts. A system of transfer or rotation of employees from one seat of work to another must be followed by the business.
- iv. **Rotation of employees:** A good system of internal check should not allow persons having custody of assets to have access to the books of account. A system of transfer or rotation of employees from one seat of work to another must be followed by the business.
- v. **Automatic check:** A good system of internal check must provide for an automatic checking of the work of one clerk by the other.
- vi. **Reliance:** No clerk of the business should be relied upon too much.
- vii. **Safeguard:** Safeguard should be prescribed to keep un-used cheque books, files and securities etc.
- viii. **Supervision.** A strict supervision should be exercised to ensure that the prescribed internal checks and procedures are fully operative.
- ix. **Formal sanction:** No deviation should be allowed from the establishment procedure till it is formally sanctioned by the top official.
- x. **Periodical review:** The system of internal check should be reviewed from time to time to introduce improvement.

2.7.3 Advantages and Disadvantages of Internal Check

Advantages of Internal Check

The application of a good system of internal check in an organisation brings the following advantages:

- i. Where internal check is efficiently applied, it becomes difficult for members of the staff to indulge into fraudulent practices, the chances of successful frauds are remote as it involves independent and automatic checking of various transactions and the record thereof.
- ii. Any dishonesty or irregularity in the concern by members of the staff can be detected before they assume any complication.
- iii. A particular member of the staff may be held responsible for any irregularity carried on by him as respective duties of each are clearly defined.
- iv. The chances of errors creeping in the records are reduced to a minimum and they can be detected at an early stage.
- v. It puts moral check on members of the staff and enables them to learn honesty, straight forwardness and hard work.
- vi. It ensures greater efficiency and speed since arrangement of internal check is based on division of labour.
- vii. It may also result into correct and complete records of all the transactions on easy balancing of the books which help in prompt preparation of final accounts.

- viii. It facilitates the work of the auditor to a very great extent by enabling him to rely on test checking.

Disadvantages of Internal Check

The disadvantages of internal check are discussed as under:

- i. The clerks of a business become quick and not as serious as they ought to have been.
- ii. The possibility of some of the responsible and high officials being careless increases as they feel a sort of over-confidence that the work is automatically going on efficiently.
- iii. Internal check may be quite expensive, especially for small business houses.
- iv. If the whole system is not properly organised, it may create chaos and disorder in the working of a business.
- v. The work of the auditor cannot be free from irregularities if the system is itself defective.

To provide a safeguard against its disadvantages, it is essential that the system of internal check should be adopted very cautiously and carefully. Nobody can gain say the fact that the system is of vital significance for the efficient running of a business.

2.7.4 Duties of an Auditor as Regard to Internal Check

Internal check is increasingly recognised by the auditors especially when the size of the business is large. A good system of internal check may relieve an auditor of a large part of detailed checking and the time thus saves can be given to more important matters. But, wherever the system is found to be defective, it is the duty of the auditor to check the whole transaction in detail because ultimate responsibility, in case anything goes wrong in final accounts, lies on the external auditor. In the case of a good system of internal check, his work but not the responsibility, is reduced. Statutory auditor cannot be relieved of his liability on the ground that since the system of internal check was good, he did not perform a particular function. No doubt, a good and efficient system of internal check is very helpful to the auditor but, in no way, it relieves him of his contractual responsibilities. So, the extent to which he should rely upon the system of internal check will depend upon his skill, experience and training. Operation of an efficient system of internal check helps an auditor to a great extent in the conduct of his work but it is wrong to think it will reduce his responsibilities as well. He may be relieved of a good deal of detailed checking which is automatically done in an effective system of internal check. In case of smaller business, the auditor must undertake extensive and thorough checking of all of original records, vouchers and postings etc. as far as possible. He should not rely much upon test-checking otherwise he may have not be able to trace the irregularities. It is not possible for an auditor to carry on the detailed checking of records of innumerable transactions of a big concern. Therefore, he should try to check the effectiveness of the operation of internal check system and act accordingly, as mentioned above. He should satisfy himself as to the correctness of the records as far as possible. But if the system is so faulty that it becomes difficult for him to get satisfaction as to the correctness of certain part of the records, he should mention it clearly in his report and should openly decline to share any consequential responsibility.

2.8 MEANING OF INTERNAL AUDIT

It implies the audit of accounts by the staff of the business. The staff may or may not have professional qualification for audit of accounts. The internal audit staff is permanent in nature and helps the business in early detection of errors and frauds. The objectives and functions of internal audit depend on the nature of operations and business. Sometimes the internal audit may be done by independent persons appointed for the purpose.

‘The Institute of Internal Auditors defines internal audit as, ‘Internal auditing is the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as basis for protective and constructive service to the management. It is a type of control which functions by measuring and evaluating the effectiveness of other type of control. It deals primarily with accounting and financial matters but it may also properly deal with the matters of an opening nature’. It is also covered with the verification and appraisal of the procedures and transactions. The existence of internal audit is a help to the independent auditor. In certain matters the field of both is common. Both are interested in knowing whether an effective internal control system exists to prevent errors and frauds and whether accounting systems and procedures are adequate.

2.8.2 Objectives of Internal Audit

The objectives of internal audit are as follows:

- i.** To comment on the effectiveness of the internal control system in force and to suggest ways and means to improve upon the system.
- ii.** To verify the correctness, accuracy and authenticity of the financial accounting records presented to the management.
- iii.** To facilitate the early detection and prevention of frauds.
- iv.** To ensure that the international accounting standards or the standard accounting practices are followed by the organisation.
- v.** To take up an investigation at the special request of the management.
- vi.** To ensure that the assets of the organisation are adequately safeguard and properly accounted for.
- vii.** To ensure that the organisation incurs liabilities in respect of its valid and legitimate activities.
- viii.** To ensure that the acquisition and disposal of assets are under proper authority.
- ix.** To ensure as to whether or not each unit of the organisation follows the policies and procedures as laid down by the top management.

2.9 DISTINCTION BETWEEN INTERNAL CHECK AND INTERNAL AUDIT

Internal chek is one for cheking the procedures and policies followed are complying with company policies. Internal audit is vouching of the contorl records for its intergrity and conforming to the regulatories. But Internal audit can perform internal chek depends upon the scope of their audit.

Internal Audit :

An ongoing appraisal of the financial health of a company's operations by its own employees. Employees who carry out this function are called internal auditors. During an internal audit, internal auditors will evaluate and monitor a company's risk management, reporting, and control practices and make suggestions for improvement. Internal auditing covers not only an organization's finance function, but all the operations and systems in a firm. While internal auditors are typically accountants, this activity can also be carried out by other professionals who are well-versed with a company's functions and the relevant regulatory requirements. Internal Check :

Accounting procedure or physical control to safeguard assets against loss due to fraud or other irregularities. Internal check is an element of internal control.

Internal Control :

Systematic measures (such as reviews, checks and balances, methods and procedures) instituted by an organization to (1) conduct its business in an orderly and efficient manner, (2) safeguard its assets and resources, (3) deter and detect errors, fraud, and theft, (4) ensure accuracy and completeness of its accounting data, (5) produce reliable and timely financial and management information, and (6) ensure adherence to its policies and plans.

Thus it can be summarized as

- (1) Internal check is not a specific check, but the duties of different persons are so arranged that a person's work is automatically checked by another person while carrying out the normal duty. (1) Internal audit is specifically done to check that the accounts are properly maintained and the systems are in control.
- (2) Internal check does the preventive job i.e. internal check is derived so that frauds and errors are prevented. (2) Internal audit does the detective job of identifying frauds and errors and rectifying them.
- (3) Internal check is more of process in a day to day functioning of the business. (3) Internal Audit is specific defined job.
- (4) All the persons in the organization are involved to maintain the internal check system.
(4) Specific persons are appointed to the internal audit.

2.10 SUMMARY

To summarize we can say Audit program is a plan which has a detailed procedure of what auditor is going to do. Basically, it guides with the procedure through checklists and tracking the plan which makes auditor to easily plan up.

Audit working papers are the documents which record all audit evidence obtained during financial statements auditing, internal management auditing, information systems auditing, and investigations. Audit working papers are used to support the audit work done in order to provide the assurance that the audit was performed in accordance with the relevant auditing standards. They show the audit was:

- Properly planned;

- Carried out properly
- There was adequate supervision;
- That the appropriate review was undertaken; & finally and most importantly;
- That the evidence is sufficient and appropriate to support the audit opinion.

Internal control is a means by which an organization's resources are directed, monitored, and measured. It plays an important role in detecting and preventing fraud and protecting the organization's resources, both physical (e.g., machinery and property) and intangible (e.g., reputation or intellectual property such as trademarks).

Internal check is an arrangement of as duties allocated in such a way that the work of one clerk is automatically checked by another while internal audit is an independent review of operations and records undertaken by the staff specially appointed for the purpose.

The scope of internal auditing within an organization is broad and may involve topics such as an organization's governance, risk management and management controls over: efficiency/effectiveness of operations (including safeguarding of assets), the reliability of financial and management reporting, and compliance with laws and regulations. Internal auditing may also involve conducting proactive fraud audits to identify potentially fraudulent acts; participating in fraud investigations under the direction of fraud investigation professionals, and conducting post investigation fraud audits to identify control breakdowns and establish financial loss.

2.11 LESSON END EXERCISE

1. Explain the elements of a good system of Internal Control.
2. Auditor should first review the internal check system prevalent in the concern & then proceed to audit." Discuss.
- 3 Describe a suitable internal check systems for the stores of a manufacturing concern.
4. Describe a system of Internal check for purchases & sales.

2.12 SUGGESTED READINGS

1. Contemporary Auditing : Kamal Gupta, Tata Mc-Graw Hill, New Delhi.
2. A Hand-Book of Practical Auditing: B.N. Tandon, S.Chand and Company, New Delhi.
3. Fundamentals of Auditing : Kamal Gupta and Ashok Arora, Tata McGraw Hill, New Delhi.

VOUCHING & VERIFICATION

- 3.1 Introduction
- 3.2 Objectives
- 3.3 Vouching
 - 3.3.1 Meaning
 - 3.3.2 The Voucher
 - 3.3.3 Objectives of Vouching
 - 3.3.4 Purpose of vouching
 - 3.3.5 Kinds of vouchers
 - 3.3.6 Points to be noted in Vouching
 - 3.3.7 Importance of Vouching
 - 3.3.8 Vouching of Cash Book
- 3.4 Verification
- 3.5 Difference between Vouching & Verification
- 3.6 Summary
- 3.7 Suggested Readings

3.1 INTRODUCTION

Vouching is a technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor. It is the essence of Auditing.

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. Vouching does not include valuation.

Vouching can be described as the essence or backbone of auditing. The success of an audit depends on the thoroughness with which vouching is done. After entering in all vouchers, only then can auditing start. Vouching is defined as the “verification of entries in the books of account by examination of documentary evidence or vouchers, such as invoices, debit and credit notes, statements, receipts, etc.

3.2 OBJECTIVES

After reading this unit following will be within your understanding

- Vouching
- Vouching of cash book
- verification
- verification of various items of assets & liabilities.

3.3 VOUCHING

The audit procedure begins with notification which alerts the audited party about the date and time of the procedure. Planning, as the next step, is conducted by the auditor before the audit so as to recognize the main areas of risk and areas of concern. This step is generally completed in a series of meetings with the auditing staff thus leading up to the opening meeting between the auditing staff and senior management of the auditing target and administrative staff. The process undertaken by the auditor is described by him. Management describes the areas of concern to them in addition to the schedule of employees which must be consulted. Fieldwork, the next step, starts after the results of meeting are used to regulate the final audit plans. Employees are notified about the audit, schedules are drawn up with regards to the audit staff’s activities, and initial investigation commences after identification of business procedures, interviewing key staff, testing current business practices through sampling, reviewing the law and testing internal rules and practice for equanimity.

The next step includes communication. It is essential for the audit team to be consistently in contact with the corporate auditor to elucidate procedures. When the audit is accomplished, the draft audit is prepared as the next step. The draft audit describes what was done and found. The draft is provided to the management to review, edit and suggest changes probe areas of concern rectify errors. After making final corrections, the report is provided to the management for the seventh step, the management response. Management is then asked for answering the report by stating whether they agree with the cited problems, the plan to rectify noted problem and the anticipated date for addressing all the issues.

The final meeting is projected to close loose ends, discuss the response of the management, and address the audit scope. The ninth step includes report distribution, where the final audit report is given to apt officials inside and outside the audit area. The final step includes the audit feedback which involves implementing the suggested changes as well as the auditors review and verifies the quality, adherence, and effects of these changes.

3.3.1 Meaning

Vouching is a technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor. It is the essence of Auditing:

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. Vouching does not include valuation.

Vouching can be described as the essence or backbone of auditing. The success of an audit depends on the thoroughness with which vouching is done. After entering in all vouchers, only then can auditing start. Vouching is defined as the “verification of entries in the books of account by examination of documentary evidence or vouchers, such as invoices, debit and credit notes, statements, receipts, etc. The object of vouching is to establish that the transactions recorded in the books of accounts are (1) in order and have been properly authorized and are correctly recorded. “Simple routine checking cannot establish the same accuracy that vouching can. In routine checking, entries recorded in the books only show what information the bookkeeper chooses to disclose, however these entries can be fictitious without any vouching or vouchers. By using a vouching or a voucher system a company will have concrete and solid documentation and evidence of expenses, capital, and written proof in audits. Vouching is the essence or backbone of auditing because when performing an audit, an auditor must have proof of all transactions. Without the proof provided by vouching, the claims provided by the auditor are just that, only claims. In most cases, hard to detect frauds can only be discovered through the use of vouching. It was declared that it was essential that due care and attention are to be given to vouching in auditing.

According to **Dicksee** “Vouching consists of comparing entries in the books of accounts with documentary evidence In support there of.”

According to **Joseph Lancaster** “it is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries. This is, however, quite wrong, for vouching comprises such an examination of the ledger entries as will satisfy the auditor, not only that the entry is supported by the documentary evidence but it has been properly made upon the books of accounts.”

A **Voucher** is documentary evidence in support of a transaction in the books of account. The act of establishing the accuracy and authenticity of entries in the account- books is called Vouching, Ronald A. Irish of Australia defines Vouching as “vouching” is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction. Vouching is considered to be the essence of auditing and therefore the auditor should be very careful

while vouching. Vouching means to substantiate an entry in the books of account not only with any documentary evidence such as agreements, receipts, Counterfoils of a receipt book or paying in book, contracts, but also to see that the transaction has been properly authorized, recorded and entered in the books of account.

Vouching means “testing the truth of items appearing in the books of original entry”. The success of an auditor in vouching depends upon his intelligence, critical bent of mind, common sense, observation and tact with which he handles his work.

To conclude, we can say that Vouching means checking of additions, ledger- postings, extracting of balances in the ledger etc. It is documentary evidence in support of a transaction in the books of account.

3.3.2 The Voucher

A transaction is recorded in the books only when documentary evidence is available to support the transaction. It may be a receipt, counterfoil of a receipt, resolution passed in a meeting, cash memo, pay-in-slip, purchase invoices, sales invoices, minutes of a meeting. All such documentary evidence is known as vouchers.

Eric L. Kohler defines a Voucher:

- (i) A document which serves as an evidence of a disbursement of cash. For example, a receipted bill, a cancelled bill, petty cash receipt, the carbon copy of a cheque.
- (ii) A document serving an evidence of the authority to disburse cash. For example: an approved invoice from a supplier, a pay roll.
- (iii) A form (used with a voucher system) to which bill, receipt and other evidences of indebtedness are often attached. Showing the authority for the payment, the particulars of settlement, and other relevant details, a disbursement voucher.
- (iv) The written evidence of a business or accounting transaction sometimes contained in a single document without attachments. For example: a journal voucher.

3.3.3 Objectives of Vouching

Main objective of vouching is to find out the regularity or irregularity of transactions, frauds and errors. Regularity means maintaining record and performing the work compliance with the rules, regulation and law. But irregularity means doing the work crossing to the line of rules, regulation and laws. Some of the major objectives of vouching are given below:

1. To Detect Errors And Frauds

All transactions are to be supported by evidence. Each document should be proved by authorized authority. With the help of vouching we can detect errors and frauds by verifying each transaction. Planned fraud can be detected through vouching.

2. To Know The Truth Of Account

Each and every transaction is checked and ratified on the basis of support document. So, we can easily know the truth of account.

3. To Find The Unrecorded Transactions

Each and every transaction is checked and ratified on the basis of document. Vouching helps to find out the unrecorded or missing transactions. If any voucher is found unrecorded, auditor can suggest to record such transactions.

4. To Know That All The Transactions Are Authorized

If the transactions are made on the consent of concerned authority, such transactions are known as authorized transactions. If transactions are not authorized, such transactions can be fictitious transactions. So, such fictitious transactions can be found with the help of vouching.

5. To Know That Only The Business Transactions Are Recorded

Sometimes, transactions are performed for individual purpose but payment is made out of

business. Such transactions should not be recorded in account of business. If such transactions are recorded, we can find it with the help of vouching. To know the real profit or loss of business, such transactions are to be separated.

3.3.4 Purpose of Vouching

1. **Proper Evidence:** The purpose vouching is to note that proper evidence is available for every entry. The signatures, initials and rubber stamp are evidence that document has been authorized and checked.
2. **Proper Authority:** The purpose of vouching is to note that there is proper authority behind every transaction. In the absence of any signature of manager the transaction are not acceptable at all.
3. **Right Period:** The purpose of vouching is to check that date of the vouchers relate to accounting period. The adjustments in books are made on the basis of current year record of transactions.
4. **Correct Amount:** The purpose of vouching is to check that correct amounts have been recorded in the entry. The vouching is useful to record only correct amounts in the books of accounts.
5. **Capitals and Revenue Analysis:** The purpose of vouching is to examine the analysis of transaction into capital and revenue. The expense relating to one year is treated as revenue otherwise it is called capital.
6. **Purchase for Business:** The purpose of vouching is to check that purchase relate to the nature of business. The private purchase cannot be recorded as business due to vouching.
7. **Arithmetical Accuracy:** The purpose of vouching is to see the arithmetical accuracy of books of accounts. The auditor to confirm that books are accurate can check the total subtotals, casting and posting.
8. **Postings:** The postings of total from journal to the ledger can be voucher by the auditor. He can see through vouchers that posting are complete and correct.
9. **No Error:** The purpose of total vouching is to check that there are no errors in the books of accounts. The errors are the result of carelessness or over work. But audit staff is not over loaded so they can locate error.
10. **No Fraud:** The purpose of vouching is to examine that no fraudulent payments are made. The fraud can be committed due to matching of minds of employees and customer. The auditor can vouch the entries top disclosed such frauds.
11. **Castings:** The purpose of vouching is to check castings or loads. The auditor can calculate all total by himself. He can compare the totals with books to maintain accuracy.
12. **Cast at Bank:** The purpose of vouching is to determine true cash at bank. He can vouch receipt and payments. The result is that he can check whether cashbook is correct or not.
13. **Cash Balance:** The purpose of vouching is to check that cash in hand figures are facts. The cash can be counted. He can compare it with cashbook. He can apply test checking to determine accuracy.
14. **Reporting:** The purpose of vouching is to form an opinion for the purpose of reporting. In case of true and fair view there is good report. In the absence of such result there may be qualified report.

3.3.5 Kinds of Vouchers

Vouchers can be classified into two types:

1. Primary vouchers, and
2. Collateral vouchers.

1. **Primary vouchers:** When written evidence is available in original, it is known as primary vouchers. For example: Cash memo, purchase invoice.
2. **Collateral Vouchers:** In certain cases evidence in original are not available. Copies of such evidences are made available for the purpose of audit. Aim is satisfy auditor regarding to the correctness of transaction recorded. For example: carbon copies of sales invoices, copy of resolution passed at a meeting. Following are the example of vouchers for various transactions

Table 1: Examples of Voucher

Name of Transaction	Vouchers Available
	Cash memos, pay-sheet, receipt received, pay-sheets agreements and demand notes.
	Carbon copies of receipts, counterfoils of receipts issued, contracts, correspondence.
	Invoices, copies of orders and Correspondence goods inward register etc.
For sales	Goods outward register, order, copies of invoices, cash memos etc.
	Last year's balance sheet entries, bills payable, bill receivable etc.

Points to be noted in Vouching

While examining the vouchers, the auditor must bear in mind the following points:-

1. All the vouchers are consecutively numbered and filed in order of the entries in the accounts. If the client has not done so, the auditor has a right to ask him to do so.
2. He should pay attention to the dates, which must correspond with the cash book, name of the party to whom the voucher is issued, the name of the party issuing the voucher and the amount.
3. The Voucher inspected should be cancelled by a stamp lest they may be produced again. Subsidiary documents such as statements, invoices etc., relating to such a voucher should also be cancelled. In case, stamp is not available, the audit clerk should put his signature on

the face of the voucher.

4. Special attention should be paid to those vouchers which are in the personal name of one of the partners, directors, manager or secretary, etc., as such a voucher may not relate to the business.
5. He should see that every voucher is passed as in order by a responsible officer. The signature of the officer should be noted. If the receipt is a printed one or it bears a rubber stamp of the name of the firm, the voucher should be taken as a genuine one.
6. He should also note, whether the voucher is stamped, if the amount of voucher is above twenty rupees.
7. He should also find out the nature of payment as to whether it relates to the business.
8. He should see as to which account the payment is posted-revenue or capital. This is important as wrong posting will affect the profit and loss account and ultimately the balance sheet.
9. Note should be made of any item which requires further information or evidence which is available from partnership deed, contracts, articles of association, minute book, leases etc.
10. The audit clerk should not take the help of any member of the staff of the client for an explanation while vouching receipts.

3.3.7 Importance of Vouching

Vouching is the act of checking evidential documents to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. Thus, it is important for an auditor due to the following reasons:

1. Vouching Is The Backbone Of Auditing

Main aim of auditing is to detect errors and frauds for proving the true and fairness of results presented by income statement and balance sheet. Vouching is only the way of detecting all sorts of errors and planned frauds. So, it is the backbone of auditing.

2. Vouching Is The Essence Of Auditing

Auditing not only checks the accuracy of books of accounts but also checks whether the transactions are related to business or not. All the transactions are performed after the prior approval of concerned authority or not, transactions are real or not because an accountant may include fictitious transactions to commit frauds. All these facts can be found with the help of vouching. So, vouching is essential for auditing.

3. Vouching Is Important To See Whether Evidences Are Correct Or Not

An auditor checks the books of accounts to detect errors and frauds. Frauds may be committed presenting duplicate vouchers. All the small and big amounts of frauds can be detected with the help of vouching. So, all the evidential documents and records are to be checked carefully and in detail by an auditor which is the scope of vouching.

Therefore, it can be said that vouching is the heart of auditing because without the work of vouching, the work of auditing cannot be performed.

The special considerations to be borne in mind by the auditor in the course of vouching.

1. Date of the voucher
2. The name of the party
3. Tick and audit rubber stamp
4. Authorisation by the authorised person
5. Revenue stamp of Re. 1 if it exceeds Rs.5000/-
6. Transaction relates to business
7. Revenue and capital
8. Amounts in words and figure
9. Account head
10. No assistance of member of clients staff to be taken for checking receipts
11. Not to accept receipted invoice
12. Missing vouchers
13. Important documents
14. Vouching of cash transaction
15. Proper filing
16. Signature of payee
17. Nature of payment
18. Noting in the audit note book
19. Alteration
20. Voucher control number

3.3.8 Vouching of Cash Book

Before starting the vouching of the cash book, auditor should enquire about the system of internal check in operation. There are lots of chances of misappropriation of cash if there is no well, organised system of internal check. He should enquire as to the duties of the cashier, and whether he has access

to the ledger and other books of original entry. If it is so, there are chances of fraud and therefore he should be vigilant.

This type of danger is usually in small concerns where a clerk is assigned two or more jobs. The following system of internal check as regards receipt and payment of cash is suggested:-

1. When cash is received, it should be acknowledged by means of a printed receipt which should have counterfoils. Cashier should not sign the receipts and counterfoils. The receipt should be consecutively numbered and should be kept under lock and key. Spoiled receipts should be cancelled and must not be detached from the counterfoils. No blank counterfoils should be accepted.
2. As soon as cash is received, it should be entered in a rough cash book or diary.
3. Remittances should be opened by the cashier in the presence of a responsible officer who should not be connected with the cashier's office. All cheques received should be crossed 'Not Negotiable-A/C Payee only'
4. All the receipts of the day should be deposited in the bank at the end of the day or the next morning.
5. Bank reconciliation statement should be prepared frequently by the cashier and also by someone else.
6. The cashier should not have any control over the ledger.
7. Petty cash should be organised under the imprest system.
8. Castings of cash book should be independently checked.
9. Internal Control over the preparation of wages sheet to prevent fraud and manipulation should be exercised.
10. All payments as far as possible, except for petty cash, should be made by cheques.
11. This should be so organised that chances of misappropriation are reduced to a great to minimum.

3.3.8.1 Vouching Debit Side of Cash Book

After satisfying himself that there is a good internal check system regarding the receipt and payment of cash, the audit clerk should now proceed to vouch the debit side of the cash book. It is rather very difficult to voucher the receipt of cash as some entries might have been omitted altogether and therefore only indirect evidence is available. He should check a few items at random and if he finds that they are in order, he may assume that the other will be correct but he must not omit to compare the rough cash book or the diary with the cash book. If he fails to do so and latter on a fraud is detected, he might be held responsible. If he finds that there is a time-lag between the two dates, he should go deeper in to the matter as it is possible that money might have been received in between the two dates and misappropriated.

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

1. **Opening Balance:** This should be compared with the balance shown in the duly audited balance sheet of the previous year. This is done to see that the actual balance has been brought down.
2. **Cash Sales:** There are greater chances of fraud under this head. The salesman may sell goods and may not make an entry in the cash book and thus misappropriate the money.

The auditor should check here and there a few items from the salesman summaries, cashier's summaries and the gate-keepers extracts. If the auditor does not do so, he will be held liable for any fraud which remains undetected.
3. **Receipts from Debtors:** The auditor should vouch cash received from debtors to whom goods had been sold on credit in the past.
4. **Income from interests, dividends etc:** Interest received on account of fixed deposits in the bank should be vouched with the bank pass book. Sometimes a fictitious pass Book is produced. Care must be taken to see that it is genuine one. Dividends received can be vouched with the counterfoils of "tops" of the dividend warrants.
5. **Loans:** The receipt of loan should be vouched with the agreement with the lender. The security offered should be indicated in the balance-sheet. The interest due but not paid at the balance sheet date should be adjusted in the account.
6. **Rent Received:** The auditor should examine the Lease Deeds and agreements to ascertain the amount of rent payable, the due date, the provision regarding the repairs etc. Rent received may also be compared with the "rent rolls" if they are maintained in the case of owners of large estates
7. **Bills Receivables:** B/R books should be compared with Cash Book and the Pass Book to see that the amount has been received on the due date. Contingent liability should be shown on the balance sheet in respect of bills receivable discounted but which have not matured at the date of the Balance Sheet.
8. **Commission:** Commission a/c should be checked with the accounts of the parties from whom commission has been received. Agreement with the parties regarding the rate of commission should be inspected. Counterfoils of the receipt should be checked with the amount of cash book.
9. **Subscriptions:** Subscriptions received by a club or school, etc. should be checked with the Register of subscribers and the counterfoils of the receipts.
10. **Insurance claim money:** Insurance money received against a claim from an insurance company should be checked with correspondence passing between the client and insurance company, the account rendered by the insurance broker or company.
11. **Share capital:** In the case of firms, the Partnership Deed should be examined to find out the amount of capital contributed by each partner.
12. **Miscellaneous Receipts:** Correspondence, contracts or any other document will help auditor to vouch such transactions.

3.3.8.2 Vouching Credit side of Cash Book

When the auditor has finished the vouching of the debit side of the cash Book and having satisfied himself that there is a good internal check system, he should now proceed to vouch the cash payments which means that he should satisfy himself that the payments have been actually made:-

- (a) To the right person or parties.
- (b) For the business itself.
- (c) Have been properly recorded in the Books of account.
- (d) Have been sanctioned by a person holding some authority.

The detection of misappropriation money depends largely upon an intelligent and careful vouching of this side of the cash book.

Some of the important items which usually appear on the credit side of the cash books and the duties of an auditor thereto are given below:-

1. **Wages:-** An important entry, which is usually a big one, is that of wages, there are many chances of misappropriation of cash under this head, Before the auditor proceeds with his work, he should make a thorough investigation regarding the internal check system which is in operation. He should satisfy himself that the arrangement for the preparation of wages sheets and the system of payment is adequate so as not to leave any loophole for fraud. If he finds that there is any loophole, he must draw his liability; the chances of fraud or error are more when there is:-
 - (i) The inclusion of fictitious names of dummy workers in the wage book.
 - (ii) Possibility of clerical errors.
 - (iii) Over-stating of rates of wages.
 - (iv) Conversion of Unpaid wages.
 - (v) Over-footing of pay roll sheets.
 - (vi) Understatement of deductions.
2. **Payment to creditors:** Money paid to creditors on open account can be vouched with the receipt issued by the creditors acknowledging the receipt of money. Money due to them can be compared with the accounts of suppliers of the goods.
3. **Capital expenditure:** Capital expenditure means money spent on acquiring fixed assets. The duty of an auditor in this connection is to see that the payment is in order, that it is duly authorised and that the money spent has been properly capitalised.
4. **Expenses Incurred in acquiring fixed assets:** expenses incurred in acquiring the fixed assets, e.g. auctioneer's commission, brokerage, registration fees, architects fees, which can be vouched by their respective accounts, should be capitalised.
5. **Bills Payable:** Returned bills duly cancelled should be examined. It would be a sufficient evidence of the amount having been paid. Reference may be made to the Bank Pass and Bills payable books.

6. **Bank charges:** Bank charges such as commission, interest on overdraft and loan, etc. should be examined with the bank Pass Book. He should check the calculation of interest.
7. **Postage:** The Postage book should be compared with the cash book or the petty cash book and the balance of stamps in hand should be counted. Where a franking machine is in use the receipt issued by the post office for the payment made should be examined.

3.4 VERIFICATION

Verification means ‘Proving the truth’, or confirmation’. One of the most important duties of an auditor in connection with the audit of the accounts of a concern is to verify the assets and liabilities appearing in the balance sheet. He has not only to examine the arithmetical accuracy and bonafide of the transactions in the books of accounts, but he has also to see that the assets as recorded in the balance sheet actually exist. He has therefore, to see whether a particular asset as recorded in the balance sheet on the day of closing of the books of account actually exists or not. If he fails to verify the asset, he will be held liable for any damage suffered by the client if he fails in his duty.

Spicer and Pegler have defined verification as “it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets”. Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available.

Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet. Thus, verification includes verifying :-

1. The existence of the assets
2. Legal ownership and possession of the assets
3. Ascertaining that the asset is free from any charge, and
4. Correct valuation

Of course it is not possible for the auditor to verify each and every asset. It was held in Kingston Cotton Mills case that “it is not part of an auditor’s duty to take stock. No one contend that it is. He must rely on other people for the details of stock in trade in hand”.

However, as per the decision given in Mc Kesson and Robins case (1939) the auditor must physically inspect some of the assets. Now the auditor has to report whether the balance sheet shows true and fair view of the state of affairs of the company. Hence, he is required to verify all the assets and liabilities appearing in the balance sheet. In case of failure, the auditor can be held liable for damages.

According to the ‘statement of auditing practices’ issued by ICAI, “the auditor’s object in regard to assets generally is to satisfy that :-

1. They exist.
2. They belong to the client.
3. They are in the possession of the client or the persons authorized by him.

4. They are not subject to undisclosed encumbrances or lien.
5. They are stated in the balance sheet at proper amounts in accordance with sound accounting principles, and
6. They are recorded in the accounts.

3.4.1 Components, Objects, Advantages & Techniques of Verification

Components

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

Having satisfied himself that a particular asset does exist either by actual inspection or otherwise and that it is free from any charge, he has to proceed further to find out whether the assets are properly valued.

Objects

Following are the objects of verification of assets and liabilities

1. To show correct valuation of assets and liabilities.
2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business
3. To find out the ownership and title of the assets
4. To find out whether assets were in existence
5. To detect frauds and errors, if any
6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
7. To verify the arithmetic accuracy of the accounts
8. To ensure that the assets have been recorded properly.

Advantages

Advantages of verification are as under :-

1. It avoids manipulation of accounts
2. It guards against improper use of assets
3. It ensures proper recording and valuation of assets
4. It exhibits true and fair view of the state of affairs of the company.

Techniques

1. Inspection : It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.
2. Observation : The auditor may observe or witness the inspection of assets done by others.
3. Confirmation : It means obtaining written evidence from outside parties regarding existence of assets.

3.4.2 Valuation & Verification of Assets

Valuation of assets is an important part of their verification. The correct profits can not be calculated unless the assets are properly valued. Only then the balance sheet will reveal the true and fair position of the financial affairs of the business. The valuation as such is to ensure the correct valuation of the assets while in verification, the auditor has to verify the authority, and the existence of the property also besides its valuation. Thus valuation means to test the exact value of an asset on the basis of its utility. Normally, valuation is done after deducting the depreciation for the value of an asset. If proper depreciation on assets is not provided for, the profits will be overstated or understated which will have adverse effect on the company's solvency. The auditor should consider the following points while valuing the assets:

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

Mode of valuation of different types of assets.

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

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

Auditor's position as regards valuation of assets :

It is not an auditor's duty to determine the values of various assets. It has been judicially held that he is not a valuer or a technical man to estimate the value of an asset. But he is definitely concerned

with values set against the assets. He has to certify that the profit and loss account shows true profit or loss for the year and balance sheet shows a true and fair view of the state of affairs of the company at the close of the year. Therefore he should exercise reasonable care and skill, analyse all the figures critically, inquire into the basis of valuation from the technical experts and satisfy himself that the different classes of assets have been valued in accordance with the generally accepted assumptions and accounting principles. If the market value of the assets are available i.e., in the case of share investment then he should verify the market value with the stock exchange quotations. If there is any change in the mode of the valuation of an asset, he should seek proper explanation for it. If he is satisfied with the method of valuation of the assets he is free from his liability.

3.4.3 Verification of Assets

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

In case where property has been mortgaged, the auditor should obtain a certificate from the mortgagee regarding the possession of title deed and outstanding amount of loan. In

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

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

2. **Furniture, Fixtures and Fittings :** In case the assets have been acquired during the current accounting period, the auditor should examine the invoice of the dealers. It should be noted that adequate depreciation has been written off, based upon the working life. In the case of fixture and fittings on lease hold premises, the whole cost should be written off over the period of the lease of their estimated working life, whichever is shorter. A stock register to record furniture etc., purchased should be maintained. The old and unserviceable furniture must be discarded by a responsible officer. He should ask the management to prepare an inventory and reconcile it with the stock register.
3. **Plant and Machinery :** In case the machines are purchased in the current accounting period, the invoices and the agreement with the vendors should be verified. The auditor should 'examine the plant register in which particulars about the cost, records about sales, provision for depreciation, etc., are available. He should prepare a list of each machine from the plant register and should get the list certified by the works manager as he is not a technical man and therefore he has to depend upon the advice of the works manager regarding their valuation, etc. He should see that plant and machinery account is shown in the balance sheet at cost less depreciation after making proper adjustment regarding purchases and sale of some parts effected during the year under audit. In case any plant and machinery has been scrapped, destroyed or sold, he should ascertain that the profit or loss arising thereon has been correctly determined.
4. **Goodwill:** Goodwill should be shown as an asset in the balance sheet only if it has been purchased. In such a case goodwill should be shown at cost. But if the price paid for goodwill has not been fixed specifically in the contract of sale, the amount of goodwill will be the difference between the total purchase price and the other assets at agreed valuations, less any liabilities taken over from the vendors.

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

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

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

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

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

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

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

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

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

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

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

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

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

10. **Investments** : Investments include government securities, shares, debentures, etc. When the number of investments is very large, the auditor should ask for a schedule of investments held by

the client containing various particulars like name of the securities, date of purchase, nominal value, cost price, market price, etc., and examine the same. He should see that the asset has been shown separately in the balance sheet.

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

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

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

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

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

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

- a) All time barred debts must be treated as bad. So an auditor must check up the period of the debt and see that necessary provision has been made for such bad debts.
- (b) He must check the cases of those individual debtors who are not regular in payment of debts according to the terms of agreement and ascertain the collectibility of the debts in each case. Amounts that are definitely not collectible should be written off.
- (c) In case of those debtors, who have been adjudicated as insolvent or whose cheques or bills have been dishonoured proper provision must be made.
- (d) Provision must also be made for the amounts owing from those debtors against whom suits for realisation of debts are pending in the law courts.

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

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

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

14. **Cash-in-hand :** The auditor should carry out cash verification at the end of the year and or by way of a surprise check any time during the year. In the former case, he should visit the clients office on the last day of the closing of the financial period and count the cash-in-hand and compare it with the balance as shown in the cash-book. He should also count the balances of the petty cash book, stamps and I.O.U's in hand. In case there is any shortage, he must

report it to the accountant and obtain a certificate to that effect from him. He should insist on the production of all funds in the same location simultaneously. If the cashier has access to funds belonging to other entities like associated companies, staff clubs”, etc., the auditor should seek the cooperation of these entities in ensuring that all funds are checked simultaneously as there is a danger that shortages in one account may be made up from the balance in another account. Where the whole or a part of the cash is maintained either at an upcountry branch or factory and is not therefore conveniently accessible to the auditor for verification, the client may be advised to deposit the entire amount of cash in hand on the last day in the bank. The auditor should carry out a surprise cash verification whenever he visits such an up country branch or factory during the course of his audit.

15. **Cash-at-Bank** : The auditor should compare the balance as shown in the pass book with the balance as shown in the bank column of the cash book. In case of difference, bank reconciliation statement should be prepared. In order to avoid the presentation of fictitious pass book, he should also obtain a letter of confirmation from the bankers. Separate certificates should be obtained for fixed deposits, current account and saving bank account, etc., from the bank.
16. **Stock-in-Trade** : The verification and valuation of the stock-in-trade is one of the most important duties of an auditor in order to arrive at the correct profit and loss of the concern under audit. In various cases, it has been decided that the auditor cannot be asked to take the stock or value it. Practically also, it is impossible for the auditor to physically verify every item of the stock-in-hand because of various reasons i.e. limited time and the lack of technical knowledge etc., still he has to exercise reasonable care in regard to stock verification and valuation. He should make enquiry into the system of internal check, the method of stock taking and the basis of valuation.

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

Method of Stock Taking

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

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

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

Valuation of Stock-in-Trade

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

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

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

Market Value

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

1. **Replacement cost method:** It is the cost of replacing an asset at the date of the balance sheet. It means the price at which similar types of goods can be presently purchased from the market.
2. **Net Realisable value method:** Is means the price at which the goods can be sold in the market after deducting the necessary selling expenses.

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

Valuation of different items of stock

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

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

2. **Semi-Finished goods :** In case of semi-finished goods which are in the process of manufacture at the date of balance sheet, they will be valued at the cost price of the raw materials used, plus the proportionate amount of wages and other direct expenses and a percentage of overhead expenses. The auditor should see that the amount in respect of selling and office expenses are not included.
3. **Finished goods :** These goods may be of two types. Firstly, the goods which have been manufactured and are in a deliverable state, will be valued at the manufacturing cost, that is, material, labour and a proportion of factory expenses. If the cost price of the manufactured goods is higher than the market price and they must be valued at market price. Secondly, in some trading concerns goods are purchased for the purpose of resale. The cost of such goods would be the aggregate of the invoice price (including sales tax, excise duty etc.) and other direct expenses like carriage etc.
4. **Stores :** These are goods which may be in hand at the date of the balance sheet stores are held for use and not for sale in the original form. Examples are Coal, Oil, Fuel etc. They should be valued at cost price. If the market price of such stores have gone down, it has been suggested that they must be written down.
5. **Spare Parts :** Spare parts are used in connection with the maintenance of production facilities. The auditor should get a list of such parts from the works manager. They should be valued at cost price and are not required to be written down to the market value if that value is lower at the date of the balance sheet.
6. **Goods on Consignment:** It may happen that at the date of the balance sheet, the whole of the consignment or part of it may not have been sold. Such unsold consignment of goods should be valued at cost price, plus proportionate expenses, etc., but it should not be valued at higher price than market price of similar goods. The anticipated losses should be considered while valuing such stock of goods.

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

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

- (i) **Physical Verification of Stock-in-Trade :** This part of auditor's duty is subjected to a great amount of controversy. As a matter of fact an auditor may or may not possess the technical knowledge to verify that the stock-sheets are correct and even if he possesses the necessary knowledge it is not possible for him to inspect each and every item of the stock. The first guiding legal cases in this direction are Kingston Cotton Mills Case and Irish Woollen Co. Ltd. V/s Tyson and others. It was held in these cases it was held that an auditor is not a valuer and it is not his business to take stock and if there are no suspicious circumstances, he is entitled to depend upon the

representation of officials. He is not guilty of negligence if he accepts a certificate of such persons as to the value of stock. At the same time it was also stated that he must exercise reasonable care in regard to stock verification and valuation. For instance, he should make enquiry into the system of internal check, the method of stock taking and the basis of valuation compare the rough stock sheets with fair stock sheets etc.

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

In India, the accepted practice of the American Accountants has not been accepted. In India, it is held now that the auditor must present himself when the stock is counted by the company's staff. He should also examine the effectiveness of the system of stock control. He should check the stock sheets and if he does not do so, he will be held responsible. He should also check the calculations, additions and castings as was held in the case of Henry Squire Ltd.. Vs. Ball Baker and Co. As a result of these decisions, the practice of sending a representative by the auditor at the time of stocktaking is growing in India.

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

1. He should satisfy himself that the cost figures have been calculated on some acceptable method and are applied consistently. If the method of valuation has been changed as compared to the previous year, the auditor should mention this fact in his report and if possible, should show the effect of the changed method on the financial position of the concern.
2. He should see that the stock sheets are duly signed by the competent authority and ensure that calculations, additions and castings are correct.
3. He must examine the stock sheets and see that only goods usually dealt in are included. He should also see that fixed assets are not included. Similarly, goods on consignment or sale or return should be included at cost.
4. if the bought and sold books contain quantity columns, the balance shows by them should be compared with the stock sheets.
5. He should see that proper provision is made for the depreciation of the obsolete or defective stock and that trade discounts are deducted.
6. He should compare that stock-sheets with those of the previous year and enquire into major differences.
7. He should compare the prices at which finished goods have been sold and at which the unsold stock has been valued.
8. He should check the percentage of gross profit on sales with that of the last year and find out the causes of any material change.
9. He should see that the stock-in-trade in the balance sheet of a company is shown according to Schedule VI, Part I of the Companies Act.

3.4.4 Verification of Liabilities

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

- (a) all the liabilities have been clearly stated on the liability side of the balance sheet;
- (b) all these liabilities relate to the business itself;
- (c) they are all correct and authorised, and
- (d) they are shown in the balance sheet at their actual figures.

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

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

1. **Capital :** In case of a partnership firm the auditor should examine the partnership agreement. He must find out the original capital contributed by each partner and the rate of interest payable on capital. He must see that capital accounts are correctly maintained and verify all transactions affecting the capital accounts. He should examine the cash book, pass book, withdrawals of the partners and profits and loss earned.

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

2. **Loans : Loans may be of two types :**

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

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

payment in form of instalment and interest thereon has been received from the borrower himself.

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

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

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

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

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

- 5. Bills Payable:** The auditor should obtain a statement of bills payable and compare it with the bills payable book and bills payable account. For bills which have been met after the date of the balance sheet but before the time of audit, he should examine the cash book and bank pass book. He should ensure that the bills which have been paid are not recorded as outstanding. He should also obtain confirmations in respect of amounts due on the bills accepted by the client that are held by them.

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

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

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

3.5 DIFFERENCE BETWEEN VOUCHING AND VERIFICATION

Points of Differences	Vouching	Verification
1. Meaning	Vouching is the act of checking the records with the help of evidential documents.	Verification is the act of checking title, possession and valuation of assets.
2. Nature	Vouching is related to all the accounting documents.	Verification is specially related to the assets and liabilities
3. Examine	Vouching examines the entries relating to transactions recorded in books of accounts.	Verification examines the assets and liabilities appearing in the Balance Sheet.
4. Time	Vouching is done throughout the year.	It takes place at the end of the year.
4. Basis	Vouching is bases on only documentary examination.	Verification is based on personal as well as documentary examination.
5. Scope	It does not include verification.	It includes valuation.
6. Person responsible	Vouching is normally done by audit assistant.	It is done by the auditor himself.

3.6 SUMMARY

Vouching is a technical term, which refers to the inspection of documentary evidence supporting and substantiating a transaction, by an auditor. It is the essence of Auditing.

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. Vouching does not include valuation.

Vouching can be described as the essence or backbone of auditing. The success of an audit depends on the thoroughness with which vouching is done. After entering in all vouchers, only then can auditing start. Vouching is defined as the “verification of entries in the books of account by examination of documentary evidence or vouchers, such as invoices, debit and credit notes, statements, receipts, etc. The object of vouching is to establish that the transactions recorded in the books of accounts are (1) in order and have been properly authorized and (2) are correctly recorded. “Simple routine checking cannot establish the same accuracy that vouching can. In routine checking, entries recorded in the books only show what information the bookkeeper chooses to disclose, however these entries can be fictitious without any vouching or vouchers. By using a vouching or a voucher system a company will have concrete and solid documentation and evidence of expenses, capital, and written proof in audits. Vouching is the essence or backbone of auditing because when performing an audit, an auditor must have proof of all transactions. Without the proof provided by vouching, the claims provided by the auditor are just that, only claims. In most cases, hard to detect frauds can only be discovered through the use of vouching.

This means that the auditor must conduct vouching with great importance, if not, he can be charged with negligence which happened in the case of Armitage v. Brewer and Knott. Through this case, the importance of vouching was realized. In this case, the auditors were found to be guilty on negligence, because the auditors did not display enough reasonable care and skill in vouching the wage sheets and ended up failing to detect fraud in manipulation of these wage records and cash vouchers. When delivering the decision the Judge stated that “It was clear that a good many documents were suspicious on either face and called for Inquiry”. It was declared that it was essential that due care and attention are to be given to vouching in auditing.

Verification means ‘Proving the truth’ or ‘Confirmation’. Verification is an auditing process in which auditor satisfy himself with the actual existence of assets and liabilities appearing in the Statement of Financial position. Verification is usually conducted through examination of existence, ownership, title, possession, proper valuation and presence of any charge of lien over assets.

Thus, verification includes verifying:

1. The existence of the assets and liabilities.
2. Legal ownership and possession of the assets
3. Correct valuation, and
4. Ascertaining that the asset is free from any charge

3.7 SUGGESTED READINGS

1. R.C. Bhatia : Auditing, Vikas Publishing House, New Delhi
2. S.D. Sharma : Auditing-Principles and Practice, Taxmann Publishing House, New Delhi
3. B.N. Tandon : Principles of Auditing, S. Chand Publishing House, New Delhi
4. Kamal Gupta : Contemporary Auditing, Tata McGraw Hill, New Delhi
5. R. Sharma : Auditing - Principles and Problems, Sahtiya Bhawan, Agra

COMPANY AUDITOR

- 4.1 Introduction
- 4.2 Objectives
- 4.3 Qualifications, disqualifications and removal of company auditor
- 4.4 Appointment of a Company Auditor
- 4.5 Rights and Duties of a company auditor
- 4.6 Liabilities of a company auditor
- 4.7 Summary
- 4.8 Self-assessment Test
- 4.9 Suggested Readings

4.1 INTRODUCTION

It is an established rule that the auditors are to play a vigilant and objective role in ensuring that the shareholders' interests are well protected and that the management of the company have acted within reason. It is the shareholders who primarily depend on the good faith and efficiency of the company's auditor to ensure that company's actions in the day-to-day operations are verified.

An auditor is an independent professional person qualified to perform an audit. In accounting, an auditor is someone who is responsible for evaluating the validity and reliability of a company or organization's financial statements.

An auditor is a person who makes an independent report to a company's shareholders ('members') to show whether the company has prepared its financial statements according to company law and other financial reporting rules. The report must also state whether a company's accounts give a true and fair view of its financial affairs at the end of the year.

The auditor must be told of all general meetings of the company and can attend and speak. However, the auditor isn't entitled to vote.

Auditors help top leadership manage corporate affairs, providing guidance on various issues ranging from financial accuracy to internal controls to regulatory compliance. Auditors also help department heads identify tools and methodologies to improve operating activities, putting companies on a more financially sustainable path. Experienced corporate reviewers generally possess accounting knowledge and financial acumen.

4.1 OBJECTIVES

The objectives of this unit are:-

- to understand the qualifications, disqualifications, appointment and removal of company auditor;
- to understand the rights, duties and liabilities of a company auditor;

4.3 QUALIFICATION, DISQUALIFICATION AND REMOVAL OF A COMPANY AUDITOR

4.3.1 Qualifications of a Company Auditor

The Companies Act, 1956 has laid down the prescribed qualifications required for the auditor of a company under Section 226(1) and (2) as follows:

A person shall not be qualified for appointment as an auditor of a company whether public or private unless:

- (a) He is a chartered accountant within the meaning of the Chartered Accountants Act, 1949 and has obtained the certificate of practice.

A firm whereof all the partners practicing in India are qualified for appointment as auditor, all being chartered accountants, may be appointed by its firm name to be auditor of a company. In such a case, any partner so practicing may act in the name of the firm (Section 226 (1)).

- (b) A person who holds a certificate under the Registered Auditors Certificate (Part B States) Rules shall be entitled to be appointed and to act as an auditor of companies. Such persons are called 'Certified Auditors'. However, the central government may by notification in the Official Gazette, make rules providing the grant renewal, suspension or cancellation of such certificates and may lay down conditions and restrictions for such grant renewals, suspension or cancellation. Hence certified auditors are always subject to the rules made by the central government in this regard.

Thus the auditor of a company must either be

- (a) A practicing Chartered Accountant, or
- (b) The holder of a certificate granted to him under the Registered Auditor's Certificate Rules, 1956.

4.3.2 Disqualifications

Section 226(3) of the companies Act, 1956 further provides that the following persons are not qualified for appointment as independent auditors of a company.

- (c) a body corporate ;
- (d) an officer or employee of the company ;
- (e) a person who is a partner or who is in the employment of an officer or employee of the company;
- (f) a person who is indebted to the company for a sum exceeding Rs.1000 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.
- (g) a person holding any security of that company after a period of one year from the date of commencement of the companies (Amendment) Act, 2000.

Security means an investment which carries voting rights. Further a chartered accountant, who is a relative of a director, is also disqualified to act as an auditor of the company unless the appointment is approved by the company in its general meeting by a special resolution.

The above disqualifications extend to company's subsidiary or holding company or a subsidiary of that holding company.

Moreover, if a person is appointed due to certain circumstances, he is deemed to have automatically vacated the office of auditor's of the company from the date of his disqualification.

A disqualified person may be fined up to Rs.5000 if he acts as an auditor.

4.3.3 Removal of the Auditor(s)

Removal before Expiry of Tenure

- (1) The first auditor(s) of the company are appointed by the board of directors prior to the first annual general meeting. Such auditor(s) may be removed before the expiry of their, tenure of office by the company in general meeting by an ordinary resolution of which a special notice is to be given to the members at least 14 days before in this behalf. [Section 224(5)]
- (2) Auditor other than the first auditor may be removed from the office before the expiry of his term, only by the company in general meeting after obtaining the previous approval of the central government in that behalf. [Section 224(7)].

However, the first auditor and other auditors proposed to be removed before the expiry of their tenure, have the right to make written representation, get copies of representation circulated among the shareholders or members and be heard orally at the general meeting. [Section 225(4)].

Removal of Auditor after Expiry of Tenure

An auditor can be removed after the expiry of his tenure of office. Section 225, makes special

provisions in respect of a resolution appointing a person other than a retiring auditor or for providing expressly that a retiring auditor shall not be reappointed.

According to Section 225 as regards removal of retiring auditor or appointing another person in his place the following procedure must be followed:

- (i) Special notice, under section 190, of the intention to move such resolution, must be given to the company by a member, not less than fourteen clear days before the date of the annual general meeting.
- (ii) On the receipt of such notice, a company shall forth with send a copy thereof to the retiring auditor.

The fact that notice must be sent to the retiring auditor, and to all members prior to the general meeting, in the event of any auditor other than the retiring auditor being nominated, prevents any alteration in the appointment without the knowledge of all the members.

- (iii) If the retiring auditor wishes to make written representations thereupon, he may, do so within a reasonable length and ask the company for notification of his representations to the members of the company. By receipt of such representation the company, shall unless it is too late to do so:
 - (a) State the fact that such representation have been made in any notice of the resolution sent to members; and
 - (b) Send the copy of the representation to every member of the company to whom notice of the meeting is sent whether before or after receipt of the representations by the company.

If a copy of the representation is not sent to the members either because it was received too late to do so, or because of default by the company, the auditor may insist that the representation shall be read out at the meeting.

4.4 APPOINTMENT OF A COMPANY AUDITOR

Appointment of First Auditor [Section 224 (5)]

- (a) The first auditor(s) of a company shall be appointed by the board of directors of the company.
- (b) The appointment is to be made within one month of the date of registration of the company.
- (c) The auditor so appointed will hold office until the conclusion of first annual general meeting of the share holders.
- (d) If the board of directors fails to appoint the first auditor within one month from the date of its registration, then the shareholders by passing a resolution at general meeting may appoint the first auditor of the company.

Appointment of Subsequent Auditors [Section 224 (1)]

Section 224 (1) of the Companies Act, 1956 empowers the shareholders to appoint auditor(s) of the company the auditors so appointed are called subsequent auditors. The important points in this regard are as follows:

- (a) The first auditor(s) will hold office until the conclusion of the first annual general meeting of the company.
- (b) Every company irrespective of its nature, size at each annual general meeting, shall appoint auditor(s) to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting.

Further, we can say that an auditor is appointed for a specified term. If the annual general meeting of a company is not-held within the prescribed time limit as in Section 166, then auditor will continue to hold office till the annual general meeting is actually held

and concluded. If the annual general meeting is adjourned then the auditor will continue in office till the conclusion of such adjourned annual general meeting.

- (c) The company shall give intimation thereof to every auditor so appointed within seven days of the appointment.
- (d) Every auditor appointed at an annual general meeting is required to inform the Registrar of Companies in writing whether or not he has accepted the appointment. Such intimation should be given within a period of thirty days from the date on which the auditor receives the intimation of his appointment from the company [Section 224(1-A)].

If the auditor so appointed does not accept the appointment, the vacancy can neither be treated as casual vacancy nor a vacancy by resignation. Therefore, another general meeting has to be convened to appoint new auditor(s).

Appointment by Central Government [Section 224 (3)]

According to Section 224 (3), where at an annual general meeting no auditor(s) are appointed or reappointed, the Central Government may appoint a person to fill the vacancy within 7 days of the power of the Central Government becoming exercisable, company shall give notice of the fact to the Regional Director to whom the Central Government's power to appoint an auditor in such an event has been delegated under section 637.

Failure to give such notice will make the company and every officer of the company in default with a fine which may extend to Rs.5000.

Appointment against a Casual Vacancy

If due to death, insanity, insolvency or other disqualifications a casual vacancy of the auditor arises, the Board of Directors can fill the same under Section 224(6).

The vacancy arising out of resignation of the auditor(s) or his refusal to accept the appointment is not a casual vacancy. The auditor appointed against such a vacancy will hold office till the conclusion of next annual general meeting.

The Board has no power to fill such vacancy, even if the shareholders have authorized it in this behalf. Such a vacancy should be filled by the shareholders in general body meeting.

Appointment by Special Resolution

The Companies (Amendment) Act, 1974, introduced Section 224-A which provides that in the case of company in which 25% or more of the subscribed share capital is held, whether singly or in any combination by : -

- (a) a public financial institution or a Government Company or any State Govt., or
- (b) any financial or other institution established by any provincial or State Act in which a State Government holds not less than 51% of the subscribed share capital or;
- (c) a nationalised bank or an insurance company carrying on general insurance business;
The appointment of an auditor or auditors shall be made by a special resolution.

If the company fails to pass a special resolution, it shall be deemed that no auditor or auditors had been appointed by the company at its annual general meeting and the Central Govt. will be empowered to make an appointment. The material date for determination of holding 25% of the subscribed capital is the date of annual general meeting in which the auditor is to be appointed.

Compulsory Re-appointment

According to the provisions of section 225(2), a retiring auditor, by whatsoever, authority appointed, shall be automatically reappointed except in the following circumstances:-

- (a) Where he is not qualified for reappointed.
- (b) Where he has given to the company a notice in writing of his unwillingness to be reappointed.
- (c) Where a resolution has been passed at the meeting appointing somebody instead of him or providing expressly that he shall not be re-appointed.
- (d) Where a notice has been given of an intended resolution to appoint some person(s) in the place of retiring auditor, and by reason of death, incapacity or disqualification of that person, or of all the persons, the resolution cannot be proceeded with.

Reappointment of the retiring auditor shall also not be made, if he is already holding auditorship in the specified number of companies.

Appointment of Auditor of Government Companies or Certain other Companies.

Section 619 provides that the auditor of Govt. companies shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India, who is given power to direct the manner in which the company's accounts shall be audited and to give instructions to him in regard to any matter relating to the performance of his functions as such.

The auditor should submit a copy of his audit report to the Comptroller and Auditor General of India who has the right to comment on or supplement, the audit report in such manner as he may think fit and the same should be placed in the annual general meeting at the same time and the same manner as the audit report.

The amendment Act also introduced another section i.e. 619B which extends the provisions of section 619 to a company in which the Central Government or any state government or any Govt. Company or any Govt Corporation hold either singly or jointly not less than 51% of the paid up capital.

4.5 RIGHT AND DUTIES OF A COMPANY AUDITOR

Rights of a Company Auditor: Anybody who is given a task to perform must get the rights which may be essential for the proper performance of the task. To enable the auditor of a company to discharge his duties properly, the Companies Act, give him the following rights.

- 1. Rights of access to book of accounts:** According to section 227(1) every auditor of a company has a right to free and complete access at all times to the books, accounts and vouchers of the company. The term vouchers' includes all documents, correspondence, agreements etc., which support any of the transactions or data disclosed in the financial statements directly or indirectly. The term 'books' includes financial, statutory and statistical books. The term 'all times' means only during the normal business hours. The documents are available to the auditor, wherever they may be kept by the company.
- 2. Right to obtain information and explanation:** According to section 227(1) of the Companies Act an auditor is authorised "to require from the officers of the company such information and explanation as the auditor may think necessary for the performance of his duties as auditor, "to strengthen the position of auditor. Section 221 requires every officer of the company to furnish without delay information to the auditor, whether or not such information is available from the accounts of the company.
- 3. Right to inspect branch account:** According to section 228(2), where the accounts of any branch office are audited by a person other than the company's auditor, the company's auditor shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as an auditor. He shall also have access at all times to the books, accounts and vouchers of the company maintained at the branch office.

However, in the case of banking companies having a branch office outside India it shall be sufficient, if the auditor is allowed access to such copies of, and extracts from, the books and accounts of the branch as have been transmitted to the principal office in India.
- 4. Right to receive Notices :** According to section 231 all notices of the company and other communications relating to, any general meeting of a company, which any member of the company is entitled to have sent to him, shall also be forwarded to the auditor of the company. He is also authorised to attend the meetings and make any statement or explanation with regard to the accounts audited by him. However, he is under no duty to answer to any questions.
- 5. Right to sign the audit report:** According to section 209, only the person appointed as 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 authenticate any other document of the company required by law to be signed or authenticated by the auditor.

The auditor is to make report to the members of the company and not the Board of Directors. Auditor has the right to recommended to the board the changes in the accounting system which may be necessary. If, his recommendations are not acted upon he has the right to report the fact to the members of the company through his report.
- 6. Right to seek legal and technical advice:** The auditor of a company is entitled to seek legal and technical advice which may be needed in the performance of conduct of audit or discharge of his duties.

7. **Right to be indemnified:** For many purposes, an auditor is considered to be an officer of the company. As an officer he has a right to be indemnified out of assets of the company against any liability incurred by him in defending himself against any civil or criminal proceedings by the company, if he is held not guilty by law.
8. **Right to remuneration:** On completion of his work an auditor is entitled to get his remuneration. The rights of auditor can be limited or abridged either by the articles or resolution of the members. Any provision or resolution of this nature is ultravires and therefore void.

Duties of a Company Auditor

1. **Duty to make report:** An auditor is appointed to keep a check on the directors and therefore he has to send his report to the member even though he might have been appointed by the directors as in the case of first auditor. He is the agent of the shareholders to examine the accounts maintained and supervised by the directors and to report to them whether the directors have properly maintained the accounts.
2. **Matters to be stated in the report:** The auditor will report to the shareholders about the accounts which have been audited by him. The report shall contain the following:
 - (a) Whether or not he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit.
 - (b) Whether, in his opinion, the Profit and Loss Account referred to in his report exhibits a true and fair view of the profit or loss; and
 - (c) Whether, in his opinion, the Balance Sheet referred to in his report is properly drawn up so as to exhibit a true and fair view of the state of affairs of the company according to the best of the information and explanation given to him as shown by the books of accounts;
 - (d) 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 these books, and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
 - (e) Whether the report on the accounts of any branch office audited under section 228 by person other than the company auditor has been forward to him as required by clause (c) of sub-section (3) of that section and how he has dealt with the same in preparing the auditor's report;
 - (f) Whether or not the balance sheet and profit and loss account have been drawn up according to the requirements of the Companies Act.

The auditor shall also enquire, according to section 227(1A)

- (a) Whether the loans and advances by the company against security are properly secured and that the terms of the loan and advances are not against the interests of the company or its members;
- (b) Whether the transactions of the company which are represented merely by book entries are not prejudicial to the interest of the company;

- (c) In case of a non-banking company, whether the company has sold its investments, such as debentures, shares etc. during the year at a price less than the purchase, price;
- (d) Whether loans and advances made by the company have been shown as deposits;
- (e) Whether personal expenses have been charged to revenue account, and
- (f) Where the company has allotted shares against cash, whether the cash has actually been received and whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

If the answer to the above matters is in negative or with qualifications he shall report the reason for the answer.

How is an auditor ascertain the true position of the company's affairs? The answer is, by examining the books of the company. But he does not discharge his duty by doing this with-out enquiry, and without taking any trouble to see that the books themselves show the company's true position. But his first duty is to examine the books, 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.

The auditor has got the duty to mention in his report if he is not satisfied with regard to any point or if he could not got any information or explanation that in his opinion should be placed before the members.

If the system of book-keeping is bad the auditor should make a suggestion regarding the alternation and if the directors do not follow his suggestions, he should mention the fact in his report. Of course he cannot force the directors to change the system of book-keeping.

3. **Duty to assist-Investigator:** It is the duty of an auditor to assist the Inspectors in every possible way when the affairs of the company are being investigated. He can be asked to produce the working papers for the purpose. [Section 240 (v) (b)].
4. **It is the duty of auditor** to call for information on various points, such as
 - (a) whether loans have been properly secured,
 - (b) whether the shares, debentures, securities, etc. have been sold at less than the purchase value, and
 - (c) whether the personal expenses have been charged to revenue account etc. It may be stated that in this connection that before the companies act was amended, a duty has been cast upon the auditor to state in his report whether he has taken such steps or not. He has also to express his opinion as whether the loans advanced are secured or not. He should also state money deposited by the public with the company has been shown in the balance sheet as deposits.

In addition to the above duties of an auditor in connection with the audit of the annual accounts, the auditor of a limited company has to perform the following duties:

1. **Duty to Certify the Statutory Report:** He has to certify the correctness of the statutory report as far as :-
 - (a) the number of the shares which have been allotted by the company whether against cash or for consideration other than cash;
 - (b) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;
 - (c) an abstract of the receipt of the company and the payments made there out, etc. (section 165).
2. **Duty to Certify Profit and Loss Account in a Prospectus:** If an existing company issues prospectus, it should contain a statement of profits and losses, year-wise for the previous five years showing the rate of dividends paid each year and a statement of assets and liabilities of the company. Such a statement has to be certified by the auditor of the company (Section 56).

The statutory duties of the auditors mentioned above can be expanded but they cannot be restricted either by the Articles of Association or the Directors of the company as was held in the case of *Newton vs. Birmingham Small Arms Co. Ltd.* (1906)

4.6 LIABILITIES OF A COMPANY AUDITOR

The liabilities of a company auditor can be grouped into following categories:

1. Civil Liabilities for Negligence.
2. Liabilities under Companies Act.
3. Liabilities under other statutes
4. Liabilities for Professional Misconduct.

Civil Liability for negligence: The liability of an auditor arises where it is proved that his client have suffered a loss due to his professional negligence. Negligence implies acting carelessly or failing to perform a duty. It is an act of omission or commission which occurs because the person concerned has failed to exercise that amount of professional skill and care which is expected of him under the circumstances of the case. The auditor may be held personally liable, if it is proved, that had he exercised reasonable care and skill, he must have discovered the discrepancy. In a case it was held that if an auditor fails to show as much skill and diligence as is expected of a man of ordinary prudence, he must suffer the consequences.

In other words, to hold in auditor liable, it should be shown that:

- (a) there has been negligence in the performance of his duty;

- (b) the loss or damage is the result of his negligence; and
- (c) the loss was suffered by a client to whom he owed a duty.

As far as liability to third party is concerned; for many years, it has been the view point that in the absence of fraud an auditor has no responsibility towards persons with whom he has no privacy of contract. The fact that he has suffered damages by relying on the auditor's skill does not render him liable.

However, the latest view point is that third parties may recover damage in case the auditor knew or ought to have known that the reports, accounts or financial statement in question were being prepared for the specific purpose or transaction, which gave rise to the losses and that they would be shown to and relied upon by third parties in that connection.

Liabilities undertake Companies Act: The Companies Act provides for a number of situations under which the auditor may be held liable for negligence, mis-statement, misfeasance etc.

Civil Liability under the Act: Under Section 2(30) of the Act, the term official includes an auditor for the purpose of section 477, 478, 539, 543, 545, 621, 625 and 633. This means that auditor will also be liable under these sections.

Under section 477 the court has powers to summon and examine any officer of the company or person who is known or suspected to have in his possession, any property, books or papers of the company, or is known or suspected to be indebted to the company or is deemed to be capable of giving information concerning the promotion, formation, trade, dealings, property, books, papers or affairs of the company, the court may also acquire such a person to produce papers of the company which are in his custody.

Under Section 478, where an order has been made for winding up a company by the court and the official liquidator has made a report to the court stating that in his opinion a fraud has been committed by any person in the promotion or formation of the company or by any officer of the company in relation to the company since formation, the court may after considering the report-direct that person or the official shall be publicly examined on a day appointed for this purpose.

Section 543 deals with the power of the court in course of winding up, to assess damages against delinquent officer:

- (a) Who have misapplied, or returned, or become liable or accountable for, any money or property of the company, or
- (b) Who have been guilty of any misfeasance or breach of trust.

The company may under this section compel an auditor to contribute such sums to the assets of the company by way of compensation in respect of the misfeasance or breach of trust as the court thinks just.

Section 545 lays down the procedure for prosecution of delinquent officers, including the auditors and the members in the course of winding up. Section 633 deals with power of the court to grant relief in certain cases where in any proceedings for negligence, default, breach of duty, misfeasance or breach of trust against an officer, it appears to the court hearing the case -

- (a) that he is or may be liable, and
- (b) that he has acted honestly and reasonably, and
- (c) that having regard to all the circumstances of the case, including those connected with

his appointment, he ought fairly to be excused for the negligence, etc. the court may relieve him wholly or partly on such terms as it may think fit.

Liability for Mis-statement in Prospectus: Section 62 of the Act provides that auditor shall be held liable to compensate every person who subscribes for any shares or debentures of company on the faith of the prospectus containing an untrue statement made by him as an expert. The auditor shall be liable to compensate him for any loss or damages sustained by him by reason of any untrue statement included therein. The auditor may, however, escape the liability if he proves that:-

1. he withdrew his consent, in writing before delivery of the prospectus for registration, or
2. after delivery for registration and before allotment, he, on becoming aware of the untrue statement, withdraw his consent in writing and gave reasonable public notice of the withdrawal and the reasons therefore; or
3. he was competent to make the statement and that he has reasonable grounds to believe, and did up to the time of allotment, believe, that the statement was true.

Liability for Misfeasance: According to section 543, the court may assess damages against delinquent director and other officers of the company, including an auditor for misfeasance or breach of trust. In the case of an auditor who also comes within the definition of officer in section 2(30) for the purpose of this section, if he is guilty of neglect of duty or misfeasance, so as to cause loss to the company in any way, proceedings may be taken under this section against him either independently

or other officers or jointly with them. This section provides a simple way to the company to recover damages where any auditor or any other officer of the company is guilty of misfeasance. Time limit for bringing an action is 5 years.

Criminal Liability of an Auditor: An auditor of a company can be held guilty of criminal offences, if he willfully makes a false statement in any report, return, certificate or balance sheet etc. Under section 2(30) of the companies Act, an auditor is an officer of the company.

Under section 628 of the companies Act, "If an auditor in any report, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of any of this Act, makes a statement (a) which is false in any material particular, knowing it to be false or (b) omits any material fact, knowing it to be material, the punishment or conviction is imprisonment for a term which may extend to two years and shall also be liable to fine".

Under section 539, an auditor as an officer of the company may be prosecuted if it is proved that he has been guilty of any criminal offence in relation to company which is being wound up. On conviction the imprisonment can be for a period upto 7 years and in addition fine can be imposed.

According to section 63, an auditor is criminally liable for any mis-statement in prospectus. He shall be punishable with imprisonment for a term which may extend to 2 years or with fine which may extend to rupees five thousands or with both unless he proves either that statement was immaterial or that he has reasonable grounds to believe, and in fact he did up to the time of the issue of prospectus, that the statement was true.

Under section 545, the court may direct the liquidator of the company in the course of winding up to prosecute the auditor (past or present), if he has been guilty of any criminal offence in relation to company, or liquidator may refer the matter to the registrar of companies.

Under section 68, the auditor can be held liable for fraudulently inducing persons to invest money.

However, under section 633, the court has the power to grant relief, wholly or partly, if in any proceedings for negligence, default, breach of duty, misfeasance or breach of trust against the auditors of the company, provided the court is satisfied that the auditor acted with reasonable care and honestly.

Liability under other Statues

Under Income Tax Act: Section 278 of the Act, prescribes rigorous imprisonment upto 2 years for a person who abets or induces in any manner another person to make and deliver to the Income Tax authorities a false account, statement or declaration relating to any income chargeable to tax which he knows to be false or does not believe to be true. An auditor may also, be charged under this section in case of wrong certification of account.

A Chartered Accountant can represent his clients before the Income Tax Authorities. But, if he is guilty of misconduct he can be disqualified from practicing.

Under Rule 12A of the Income Tax rules, an auditor can face imprisonment upto 2 years for furnishing false information.

Liability for Professional Misconduct: The profession of accountancy is governed by the Institute of Chartered Accountants of India, established under the Chartered Accountants Act, 1949. The council of the Institute is empowered to decide how the profession of accountancy should be conducted in India. It has the power to provide for penalties where a member fails to follow the professional code of conduct.

Liability of Joint Auditor: The circumstances under which a joint auditor may be appointed has already been discussed. Regarding the liability of joint auditors, it is worthwhile to go through the main recommendations of the Institute of Chartered Accountants of India, which are: -

1. In such a case, the joint auditor should divide the work as far as practicable between themselves. Therefore, an auditor should not be held responsible for the work done by the other joint auditors. Each auditor should be held liable for the portion of work he has done under such arrangement.
2. It would always be good if the actual division of work to be performed by each auditor be communicated to the client if the work is divided, then each of the joint auditors will be liable for the work performed by him. If they find it difficult to give a joint report, they will be justified in giving separate reports. In the absence of division of work auditors will be jointly and severally liable for the work done by them.

4.7 SUMMARY

The role of audit committee and auditors in current scenario become very crucial. Stakeholders expect loyalty and trust from auditor and auditing committee while resolving financial facts and exposing at all fraud and fault in organization. The audit committee member's experience, relevant exposures, qualification background and in depth knowledge need to be highlighted and confirmed because if directors are experts, experienced, qualified, financial wizards, then they can have vision and foresightedness to protect stakeholders. If a company has an active and strong audit committee then independent auditors' working will be supported. Further the system of selection and appointment of auditor on their quality and experience need to be explored. Over and above laws and regulations, being responsible professionals and representatives of shareholders and investing community, Auditing committee and auditor should perform their role diligently and ethically to secure interest of not only company and investors but all stakeholders. This is possible when independent directors will have their own weight and right to ask questions to management, which in turn will give strength to auditor to be ethical.

4.8 SELF ASSESSMENT QUESTIONS

1. How a company can remove an auditor before expiry?
2. When an auditor has been appointed at the annual general meeting.?
3. Describe the procedure to be followed when it is desired to appoint an auditor other than the retiring auditor.
4. Discuss the position of an auditor with reference to Companies Act regarding his right of indemnity.
5. State the statutory duties of an auditor.
6. “An auditor of a company is sometimes, described as an agent of shareholders” Discuss.

4.9 SUGGESTED READINGS

- 1 R.C. Bhatia : Auditing, Vikas Publishing House, New Delhi
2. S.D. Sharma : Auditing-Principles and Practice, Taxmann Publishing House, New Delhi
3. B. N. Tandon : Principles of Auditing, S. Chand Publishing House, New Delhi
4. Kamal Gupta : Contemporary Auditing, Tata McGraw Hill, New Delhi
5. R. Sharma : Auditing - Principles and Problems, Sahtiya Bhawan, Agra
