B. Com. Final Year

AUDITING

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Dr. S. K. Acharya
M.Com, MA PMIR

General Editor

Prof. S. P. Pani
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UNIT - I: INTRODUCTION

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1.0 OBJECTIVES

The unit aims at familiarizing the students with the principles and methods of auditing and its application in the Business Management.

1.1 INTRODUCTION AND ORIGIN OF AUDITING

The word "audit" is derived from the Latin word "audire" which means to hear. In the ancient times, whenever the owner of the business suspected frauds they used to appoint 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 auditing practised during the ancient times was relatively crude and confined itself mainly to the verification of the accuracy of cash receipt and disbursements. Such an examination was too simple and brief, largely because of the limited number of transactions and the small amount of financial involvement.

A major break-through in the system and practice of auditing was noticed during the fifteenth century with the publication of the book on double entry system of book keeping by Luca-Pacialo in Italy in 1494. The publication marked the beginning of systematic accounting and recording of the business transactions. In his treaties, Luca-Pacialo also described the various duties and responsibilities of the auditor.

With the growth of industry and commerce during the later periods, more and more refinements were noticed in the system and practice of auditing. However auditing as it exists today can be traced back to the Great Industrial revolution in Britain during the 18th century. The subsequent scale of production of goods under the mechanized process led to a rapid increase in the requirement of capital which ultimately led to the Joint Stock Company form of business organization with the sub-division of ownership, and the delegation of managerial authority to a board of directors.

In these circumstances there was a need for the shareholders to be satisfied that the accounts presented to them by a board of directors annually, did in fact show a true and fair view of the financial position and earnings of the Company. It was for this reason, therefore, that the practice developed of appointing auditors whose duty was to verify on behalf of the shareholders the accounts of the directors and to report thereon to the shareholders. During the initial stage, one or two shareholders of the Company used to be appointed as auditors to verify the accounts on behalf of the shareholders. However these people had no technical qualifications and were not able to make effective audit.

With the rapid increase in the number and size of the companies during the nineteenth century and the growth in the interest of various outside parties in the affairs of the company, the need was felt to ascertain the actual financial condition and earning of an enterprise in the hands of independent experts. This ultimately led to the emergence of a new group of professional accountants, who audit the accounts of the business enterprises, in an independent and unbiased manner.

In India, the professional auditing was introduced by the Indian Companies Act of 1913. Initially, only a person holding Government Diploma in Accounting, could act as an auditor. In 1932 the Indian Accountancy Board was constituted under the Auditors Certificate Rules so as to give the profession a measure of autonomy. However, from 1949, with the enactment of the Chartered Accountant's Act, the entire management and control of professional auditing has been handed over to the profession itself.

1.2 DEFINITION OF AUDITING

The term "Auditing" has been defined in different ways by different authors. Some of the important definitions given by the leading authors on the subject have been reproduced below.

According to the Spicer and Pegler, "An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up so as to give a true and fair view of the state of affairs of the business and whether profit and loss account gives a true and fair view of the profit or loss for the financial period according to the best of his information and explanations given to him and as shown by the books and if not, in what respect he is not satisfied. The auditor assures himself about the accuracy and authenticity of the transactions by inspecting, comparing, checking the vouchers supporting the transactions in the books of accounts and examining the correspondence, minutes books of the shareholders and directors, memorandum of associations, articles of association and various other records available with the concern.

According to Montogomary, "Auditing is a systematic examination of the books of accounts of a business or owner organization in order to ascertain and verify and to export upon the facts regarding its financial operations and the result thereof".

Lawrence R. Dicksee defines auditing as 'an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some instances it may be necessary to ascertain whether the transactions themselves are supported by authority.

According to F.R.M. De Paula "An audit denotes the examination of a Balance Sheet and Profit and Loss Account prepared by owners together with the books of accounts and vouching relating 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 explanation given to him and as shown by books".

In the book "An Introduction to Indian Government Accounts and Audit", the Comptroller and Auditor General of India defines audit as an instrument of financial control. It acts as a safeguard on behalf of the proprietor, (whether an individual or a group of persons) against extravagance, carelessness and fraud on the part of the proprietor' agents or servants in the realization and utilization of his money or other assets and it ensures on the proprietor's behalf that accounts maintained truly represents the facts and that the expenditure has been incurred with due regularity and priority.

From the above definitions given by different authorities at different points of time, it is seen that auditing does not confine itself only to examine the arithmetical accuracy of the books of accounts. It goes further and find out whether the transactions recorded in the books of original entry are correct or not, whether they are properly authorized and whether they are to detect fraud, to ascertain the borrowing capacity, to ascertain the value of the unquoted show of a private company or to ascertain the market value of different assets of the company at the time of liquidation. Unlike investigation, auditing is conducted to find out whether the balance sheet is properly drawn up and exhibits a true and fair view of the state of affairs of the concern.

1.3 DIFFERENCE BETWEEN BOOK-KEEPING, ACCOUNTANCY AND AUDITING

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There is a great deal of difference between book-keeping, accountancy and auditing. In the business concern, the book keeping refers to the act of entering the business transactions in the books of original entry and ledgers. All these works are of a mechanical nature and require very little knowledge of accountancy. In the organization, these type of works are mostly done by the clerks. The work of the accountant starts after all the transactions are entered in the books of accounts. It is the job of the accountant to compile the accounts from the books of accounts in such a way as one is in a position to know the state of affairs of the business. The accountant also examines the various implications of the accounting statements to the management with a view to helping the management to draw various conclusions about the state of affairs of the concern and in chalking out the future policy of the organization. The work of an auditor starts after the accountant has finished his work. The auditor verifies the book entries and the various accounts to asserts their accuracy. The auditor is neither a book-keeper nor an accountant. He is required to find out whether the final accounts reflect a true and fair view of the state of affairs of the concern or not and to report his finding to the shareholders.

Difference between Auditing and Investigation

Both auditing and investigation involve examination of books and records. But the nature of examination is different in both cases. The important points of distinction between the two are given below.

(i) **Object :** The object of audit is to ascertain the truthfulness and fairness of the state of affairs and results of operations as revealed by balance sheet and profit and loss account. On the other hand, an investigation is a special enquiry into the profit earning capacity, financial position or any functional area of the concern with a specific purpose.

(ii) **Period:** An audit period of an year or six months under examination. But investigation may cover several years, say two to four years.

(iii) **Scope:** The scope of audit is very wide. But the scope of investigation is limited.

(iv) **Observance of accounting principles :** In an audit the auditor has to ensure adherence to generally accepted accounting principles and audit procedures and disclosure requirements if any. Whereas in investigation, the accountant is not at all bound by accounting and auditing principles and disclosure requirements.

(v) **Submission of Report :** The audit report is submitted to the owner. But report in case of investigation is submitted to person on whose behalf it is being conducted.

1.4 OBJECTS OF AUDITING

The basic objective of auditing has changed from time to time. During the early days when the size of the enterprise was small, operation was simple and the financial involvement was very insignificant, the basic objective of auditing was to detect the fraud, if any, committed by the employees.

After the great Industrial Revolution, the large sized corporate form of organization came into picture. This enabled the promoter to raise large amounting of capital through diffusion of ownership. In the course of time the size of the companies also greatly increased, resulting in the creation of a large number of relatively small shareholders who had no connection with the management of the enterprise. During these years, the business enterprise because of the size, number and the extent of financial involvement acquired tremendous economic significance and a number of outside parties e.g. bankers, investors, creditors, government agencies and public in general developed great stakes in the financial well-being of the enterprise. All these developments created a new awareness of the responsibilities of audit. It was felt that there should be an independent opinion as to the fairness of the financial statements provided by a management. Keeping in view the change in the economic significance of the enterprises from 1940 onwards the only audit objective of the audit has been to render an opinion as regards the truth and fairness of the presentation in the financial statements as prepared by the management and the objective of fraud detection has been relegated to the background. However, it may be noted here that the objective of fraud detection cannot altogether cease to be an audit objective because of errors and frauds exist in the books and records, the accounting statements cannot reflect the true and fair view of the position of the enterprise.

On the basis of the above discussion the objects of audit may be broadly classified into two following categories i.e. primary and secondary.

1.4.1 Primary

(1) To examine the reliability and validity of the financial statement so as to render an opinion on the truth and fairness of the presentation in those statements.

1.4.2 Secondary

(2) Detection and Prevention of errors

(3) Detection and Prevention of frauds

(1) Opinion as regards financial statements

The primary objective of an audit is to express an independent opinion about the truth and fairness of the financial state of affairs for the enterprise. According to Section 227 of the Indian Companies Act, 1956, the auditor of a company has to give his opinion (a) whether the Balance Sheet of the company gives a true and fair view of the financial position at the end of the financial year and (b) whether the profit and loss account gives a true and fair view of the profit or loss for that financial year.

In order to give his opinion about the Company, an auditor has to examine the various books of accounts, statements and other records available at the unit. He should examine the nature of the transactions and its authenticity. In his endeavour, he has to take the help of the employees of the organization and its internal control and other checking system. However, it must be emphasized here that the opinion to be expressed by the auditor must be an independent opinion. He should not allow himself to be influenced by the opinions expressed by other parties like the employees, shareholders, government or other interested parties.

2 Detection and Prevention of Errors

An accounting error may be defined as unintentional mis-statement or mis-description in the books of accounts by the employees or other officers of the enterprise. An error is generally taken to be indecent. However when it is deliberately made, it acquires the character of fraud. It is therefore necessary that the auditor must pay particular attention to every error, whatever innocence it may appear to be in the first sight.

Errors may be broadly classified into four types (a) Clerical errors (b) Errors of Principle (c) Compensating errors (d) Errors of duplication.

(a) Clerical Errors

Clerical errors are committed in posting, totaling and balancing. Such errors may be grouped under two heads, (i) Errors of Omission (ii) Errors of Commission.

The errors of omission occur, when a transaction has not been recorded in the books of account either wholly or partially. Some of the examples of the first type of error may be omission to enter the invoices in the purchase daybook, the omission of sales from the sales day book, the non-provision of interest, rent, salaries and other outstanding dues. These types of errors are difficult to detect as they will not affect the trial balance. However verifying the original vouchers of the purchases and sales etc. which detect this type of error.

If the omission has been made partially i.e. only one aspect of the purchases or sales have been entered in the books, then it will affect the trial balance and the omission will be easily detected.

Errors of Commission refers to wrong positing, additions, or calculations either in the books of original entry or in the subsidiary books. When any error is committed in the original books of entry e.g. in the purchase book or sales book, the error does not affect the trial balance which will be difficult to detect. However when a transaction is wrongly posted in the ledger or posted to the wrong side in the ledger, such errors can be easily detected because of the non-agreement of the trial balance. Errors committed while totaling the balances in the ledger accounts or while entering the ledger balances in the trial balance would also be reflected in the disagreement of the trial balance and would not be difficult to detect.

(b) Error of Principles

An error of principle arises when the generally accepted accounting principles are not observed while recording the transactions in the books of account. This may be largely due to the lack of sufficient knowledge of the accounting principles on the part of the book-keeping clerks. The error might also be deliberate and committed with the intention of overstating or understating the profit and losses of the enterprise. Some of the important examples of the errors of principle are wrong allocation of expenditure between capital and revenue, valuation of assets against the generally accepted accounting principles ignoring questions of outstanding assets and liabilities, inadequate provision in respect of depreciation and doubtful debt, taking credit from unearned profits and treating real liabilities as contingent liabilities.

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Most of the errors of principle do not affect the trial balance. However they affect the profit or the loss of the concern. It is therefore very important for the auditor to pay particular attention towards this type of error. The task of detecting these types of errors has assumed greater importance in these days, when it has been observed that in a majority of the cases, these errors are committed by the top management deliberately with a fraudulent intention. These are not disclosed by the trial balance or in the course of routine checking. The auditor has to make a searching enquiry and apply his independent mind and common sense in detecting their errors.

(c) *Compensating Errors*

A compensating error is one which has the effect of compensating or offsetting whether wholly or partially the effects of the other errors. As a result of this error, there may appear to be no difference between the two sides of the trial balance giving an impression that every transaction has been recovered properly in the books of accounts. However in reality a number of errors might have been hidden in the books of accounts. An example of this error has been illustrated below. Tom's account was to be credited for Rs.5000 but was credited for Rs.500 while Dick's account which was to be credited for Rs.500 but was credited for Rs.5000. Similarly the under casting of one account may be counter balanced by an over casting of another account to the same extent.

These types of errors are most difficult to detect since none of them will affect the trial balance. A complete and exhaustive scrutiny and examination of vouchers in their entry to the original books of accounts and subsequent postings in the ledger would detect these errors. In most cases because of the limited time the auditor depends upon test checks. However if the auditor comes across any such error, he may have to go for a detailed scrutiny of all transactions.

(d) *Error of Duplication*

An error of duplication arises when the same transaction is recorded twice and hence posted twice in the ledger accounts. This may happen because of the failure on the part of the book keeping clerk to distinctly mark the vouchers already entered in the books of original entry or because of the confusion caused by the invoices or vouchers received in duplicate. Since the errors of duplication are not reflected in the trial balance, it may be difficult to detect. Careful vouching is the only answer for location of errors.

Certain Common procedure for Detection of Errors

Even though it is not the duty of the auditor to locate an error, nonetheless he has to locate the error in order to report the truth and fairness of the accounting statements. Some of the common steps normally taken to detect the errors are to :

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(i) Check and recheck the total of trial balance.

(ii) Find out whether the balance of all ledger accounts have been transferred to the trial balance.

(iii) Check up, on the basis of the nature of certain accounts which will always have either debit or credit balances, whether these have either debit or credit balances, whether these have been posted to the correct side of the trial balance.

(iv) Check the totals of the ledger accounts.

(v) Find out whether all the entries of the original books of accounts have been properly posted and also check up the totals of the books.

(vi) Check up the opening balance of the ledger accounts brought up from the previous year.

(vii) If the errors are still not located, then the difference may be due to the following:

a. Where the difference in the trial balance is divisible by 9 then it is likely that there may be misplacement of figures, say 12 for 21, 24 for 42,36 for 63 and so on.

b. The error of a round sum like 10 or 1000 is often due to mistake in totaling.

3. Detection and Prevention of Frauds

Fraud refers to false representation in the books of accounts made intentionally to defraud some body. Detections of fraud is considered to be one of the important duties of an auditor. As a matter of fact, originally audit was conducted mainly with a view to detecting fraud whenever it was suspected.

A fraud may be committed in any of the following ways.

(i) Misappropriation or embezzlement of cash.

(ii) Misappropriation of goods.

(iii) Fraudulent manipulation of accounts.

(iv) Window dressing.

(i) Misappropriation or Embezzlement of Cash

The possibility of misappropriation or embezzlement of cash is relatively higher in a big organization when it is difficult to have direct control over those persons who are dealing with cash or cash transactions. Cash may be misappropriated in any of the following ways: -

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

(b) Entering less amount than what has been received.

(c) Making fictitious entries on the payment side of the cash book that has been actually paid.

In order to discover fraud under (a) and (b) above, the auditor should check the debit side of the cash book with the rough cash book, salesman's report, counterfoils of the receipt books, agent's return and their original records while the frauds under (c) and (d) can be discovered by reference to the vouchers, wage sheets, salary book, invoices etc. However the best way of checking the fraud is to prevent it. This is possible only when there is an automatic internal check system within the organization under which the receipt and payment of cash of one clerk is automatically checked by another clerk.

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(ii) *Misappropriation of Goods :*

Misappropriation of goods may be committed by way of recording purchases of longer quantities than are actually received or entering sales of larger quantities than are actually supplied and appropriating the balance quantities in cash for personal gain. This type of fraud is very difficult to detect especially when the goods are less and are of higher value. Proper method of keeping accounts in respect of purchase and sales, stock taking, stricter check on incoming and outgoing goods and periodic comparison of gross profit percentage to sales would help to avoid misappropriation of goods.

(iii) *Fraudulent Manipulation of Accounts :*

Fraud by means of manipulation of accounts is most commonly done by senior level officers of the organization like directors, or managers or other board level officials. The fraud is committed by making false entry in the books of accounts or altering, removing or destroying the true entries or omitting to enter a true entry in the books of accounts. Since the fraud is caused by higher level officers, it is very difficult to detect it. The fraud is committed either to over state the profit or understate the profit.

The profit is over stated so that the directors can get higher amount of commission, higher amount of dividend if they hold shares can dispose the shares in the market at a higher price and can assure the shareholders that every thing is well in the orgnisation.

On the other hand profit is understated to purchase the shares in the market at a lower price, to reduce or avoid the payment of income tax and to give wrong impression about the company to the competitors.

Some examples of fraudulent manipulation of accounts are non-provision of depreciation or providing less or more depreciation, undervaluation or over-valuation of assets and liabilities, showing fictitious sales and purchases, utilization of secret reserve for paying profit without disclosing the fact etc.

(iv) *Window Dressing :*

Window dressing is the practice of arranging the various assets and liabilities in the Balance Sheet with the objective of presenting a particular financial picture which does not truly represent the normal financial position of the business. Window dressing is done by recording sales and income of the following year in the current year, recording goods sent on "sale on return" basis as regular sale or treatment of normal revenue expenditure as deferred revenue expenditure.

Like detecting the falsification of account, window-dressing is also difficult to detect because it is committed by some top level officers with a particular objective.

In all these types of situations, the auditor should be very careful. He should conduct the routine checking and vouching most carefully and make searching, tactful and intelligent inquiries.

Qualification of an Auditor

Basic Qualification :

To be auditor, a person must be Chartered Accountant within the meaning of the Chartered Accountants Act of 1949. He must have the examination conducted by the Institute of Chartered Accountants of India or England. He must also secure a certificate to take up public practice of accountancy.

Since the auditor within an organization has to perform a variety of functions, he should also possess certain other qualities to be more effective in his profession. The qualities may be broadly grouped into professional qualities and general qualities.

Professional Qualities :

Under the professional qualities the auditor is expected to possess sufficient knowledge of accounting and its various principles, knowledge of the accounts of the particular business under credit and the various laws affecting the business and the knowledge of its production system. The auditor should also be quite familiar with the financial management and marketing management.

General Qualities :

Besides the professional qualities, the auditor is also expected to possess some general qualities like honesty and integrity, tactfulness, vigilance, responsibility, obligation, ability to communicate effectively and lastly common sense.

The qualities of an auditor has been spelt out in a number of judgments of different judges.

In the Kingston Cotton Mills Case, Lord Justice Lopes stated that an auditor is not bound to be a detective on approach to his work with suspicion or with foregoing conclusion that there is something wrong. He is a watch dog but not a blood hound. He is justified in believing tried servant of the company, and is entitled to rely upon their representations provided he takes reasonable care.

In the London Oil Storage Co. Ltd. Case, Justice Albertson stated that the auditor is not bound to assume when he comes to do his duty that he is dealing with fraudulent and dishonest people. If the circumstance of suspicion arises it is his duly to prescribe them to the bottom.

SELF TEST – 1

1. Define Auditing State the difference between Book Keeping, Accountancy and Auditing.
2. What is Investigation ? How does auditing differ from investigation ?
3. What is the Primary and Secondary objects of Auditing ?
4. State and give examples of different types of errors and frauds.
5. What is the qualification of an auditor ?

1.5 TYPES OF AUDIT

Auditing refers to an independent review or examination of the books of account and other records of an organization by a professionally qualified person in order to ascertain whether the financial statements have been prepared on the basis of the generally accepted accounting principles and whether they reflect the true and fair view of the financial state of affairs of the concern. The auditing as stated above is an independent auditing done by an external agency. However sometimes the enterprise may appoint suitable qualified persons to conduct an internal audit within the organization to find out the effectiveness of the information, systems control systems and other operating procedures. In addition special type audit may also be conducted to ascertain the profits for the declaration of interim dividend, detection of fraud or close examination of certain aspects of the business. Within an enterprise some audits are done only at periodical intervals which some other audits continue without any break.

Based on the above discussion, audit may be classified as General Audit and Special Audit. The General Audit may be further classified into Independent Audit, Internal Audit and Government Audit. The special audit may be further classified into interim Audit, Cost Audit, Operational Audit, Management Audit and Performance Audit.

On the basis of method of examination, audit can further be classified into Continuous Audit, periodical Audit and Balance Sheet Audit.

We have examined the main feature of different types of audit and their usefulness to the organization.

1.5.1 Independent Audit

The independent audit is conducted by professionally qualified persons who are independent of organization and do not have any interest in the organization. According to the Section 24 of the Companies Act, 1956 only qualified Chartered Accountants can be appointed as auditor of the company. The auditor examines the truth and fairness of the financial statements prepare by the accountants of the company and gives us his own opinion it. The auditor's opinion on gives a sense of credibility to the financial statements in the eyes of those for whom these statement are meant e.g. owners, creditors, investors, governmental agencies and so on.

The next outstanding feature of independent audit is the independence of the auditor. Because of the independent status of the auditor, his opinion carries weight with all types of people. Without independence from the client enterprise, his opinion will suspect and will not serve the needs of those who seek to act on the basis of the financial statements. The need for independence on the part of the company auditor has also found recognition in the Company Law which lays down that a person shall not be appointed as auditor of a company if he had any interest whatsoever, whether financial or otherwise in the company or is management.

There are two types of independent audit, (i) Statutory audit (ii) Private audit.

In all these organizations, where audit is made compulsory by law, it is called statutory audit. Statutory audit has been prescribed in the case of companies governed by the Companies Act, Banking Companies under the Banking Regulation Act, Electricity Supply Companies, Co-operative Societies, public and charitabl trust registered under various religious and other Endowment Acts, Societie registered under the Societies Registration Act, and Corporations set up under an Act of Parliament or State Legislature.

It may be stated here that in most of the organizations stated above the owners shareholders or investors do not manage the day to day affairs. It is therefore natura that they should know how the affairs of the enterprise is being managed, which onl the independent auditor can give. In all cases of statutory audit, the audit is compulso and the appointment, terms of contract and the rights, duties and the responsibilitie of the auditor are governed by the law.

In the cases of all those organizations, where audit is not compulsory by lav even though it is opted for the various benefits flowing from it, it is called Privat Audit. In India the sole proprietory concerns, Partnership firms, Joint Hindu fami business etc. are not obliged under the law to get their financial statements audite However, most of these organizations whose turnover have exceeded Rs.25 lakh get their accounts audited because of the requirements of the Income Tax Ac Similarly while obtaining any loan from any financial institution or while setting th claims of partners in dispute, or while ascertaining the going value of a concern, it necessary to make an independent audit of the organization by a qualified chartere accountant, who would give us own independent opinion about the manner in whic the business transactions are maintained and whether there is any fraud or erro by the employees of the enterprise.

It may further be stated here that since the private audit is not governed by a statute, the nature and scope of the audit is determined by the contract between t audit and the client. However even in the case of Private audit, the auditor has maintain his independence and should not do any thing under the influence or consid the dictate of his client.

1.5.2 Internal Audit :

Unlike the independent audit which is done by independent auditors, t internal audit is concluded by the employees of the organization. The internal au is a management control system which involves a continuous and objective apprai of the various activities within an organization. Its objectives are (i) whether t established management controls are adequate and an effectively maintained, whether the various records, accounts and reports reflect the actual operatio accurately and promptly and (iii) whether each division; department or other uni carrying out the plans, policies and procedures for which it is responsible.

Unlike the external auditor, the scope of operation of the internal audito much wider and in many cases his operation may extend to the non-financial a of the organization. Even though the techniques normally employed by the exter auditor are also used here, the internal auditor makes much detailed investigati and appraisal of the various activities of the enterprise. This is because of t adequate time available at his disposal and because of his thorough knowledge the various activities of the organization in comparison to the external auditor.

Unlike the independent auditor who enjoys absolute degree of independence granted to him under the statute, the internal auditor does not enjoy the same degree of independence since he is required to function within the organization under the direct control of the management. However, the internal audit should exhibit the highest degree of efficiency by examining and reviewing the various operational and financial policies, rules, procedures and activities of the organization in the best objective manner by maintaining his own honesty and integrity. If the internal audit system within an organization is efficient, the job of the external auditor can be ceased to a large extent since he can depend on internal audit, who has examined and reviewed the business transaction in detail.

1.6.3 Government Audit :

The Government as a body incurs the largest amount of expenditure in the economy. In a mixed economy like ours where some of the major manufacturing activities are undertaken by the Government needs no further elaboration. The Government audit may be broadly classified into (i) audit of Government departments, (ii) audit of statutory corporations and (iii) audit of Government companies.

(i) ***Audit of Government Departments :*** The audit of the accounts of the various government departments which are not registered as companies are done by the Comptroller and Auditor General of India, who is appointed by the President of India. The Comptroller and Auditor General besides auditing the accounts of various State and Central Government departments, also prescribe the various forms and other procedures in which the accounts should be maintained. The Comptroller and Auditor General after auditing the accounts submits this report to the President of India in case of the Union Government, who shall cause them to be placed before the Parliament. In the case of State Government departments, the report is submitted to the Governor of the respective States, who shall cause these to be placed before the state Legislature.

(ii) ***Statutory Corporation :*** The Statutory Corporations are those bodies which have been set up under the special Act of the Parliament or the State Legislature. In most of the cases; the Comptroller and Auditor General is empowered in auditing the accounts of these Corporations, like State Financial Corporation, Industrial Finance Corporation of India, Life Insurance Corporation of India, where besides the Comptroller and auditor General, the Chartered accountants are also appointed to audit the accounts. In the later case the Chartered Accountant submits his report to the shareholders in the Annual General Body meeting and his rights, duties and responsibilities are governed by the Companies Act, 1956.

(iii) ***Government Companies :*** The Section 617 of the Companies Act describes a Government company as one in which at 51 per cent of the paid up share capital is held by Central or State Government or Government companies or corporations. The Companies Act also stipulated that the auditor of a Government is to be appointed by the Company Law Board on the advice of

the Comptroller and Auditor General of India. The rights, duties, powers and responsibilities of the auditor of Government company is prescribed by the Comptroller and Auditor General from time to time in the different circulars issued by it in those direction. Normally the duties of the auditor of a government company is much wider than that of a private company. The Government auditor besides checking the various financial accounts also examines and reviews the various non-financial activities of the company which have the same bearing on the efficiency and productivity of the company.

The auditor of a Government company submits his report to Comptroller and Auditor General, who after making necessary comment on it places the report before the Annual General Meeting of the company.

1.5.4 Specific Audit :

Unlike a general audit, the scope of a specific audit is restricted in terms of areas, event or period to be covered. The specific audit is conducted with a specific object and is conducted at irregular intervals. Some of the main varieties of the specific audit are discussed below.

1.4.5 Interim Audit :

An interim audit is one which is conducted between two annual audits. The interim audit is not conducted every year. In those years, when the management of the Company wants to disclose an interim dividend besides the final dividend, the interim audit is conducted. The interim audit involves an examination and review of the books of accounts and other records of the Company till the date of the interim audit. The interim audit, when conducted helps the statutory auditor in early completion of the annual audit since a major part of the audit has already been completed by him earlier. It may however be stated here that the statutory auditor has to take a total picture of the financial position of the Company at the time of statutory audit and should not lay any extra importance on the un-audited accounts and records.

1.5.6 Performance Audit :

The performance audit is a variant of the internal audit. It is mainly concerned with ascertaining the efficiency of the various operations of the organization. Within an organization a variety of control systems operate in the area of cash receipts, cash payments, store receipts, stores disbursement, production marketing etc. The performance audit attempts to find out whether the various internal control activities within an enterprise are being carried efficiently so as to achieve their objectives. The performance audit is normally done by the staff of the internal audit department. The staff conducting the performance audit submit their report to the internal audit department which after examining and reviewing the report and passing necessary comments on them sends them to the higher authorities for taking necessary actions.

1.5.7 Cost Audit :

The cost audit may be defined as an examination and verification of the costing records of an enterprise in order to ascertain the correctness of the cost of the product processes or other services provided by the organization. The cost audit also ascertain whether the cost accounting system already installed within the organization is efficient and conform to the general objective of the accounting system.

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In India, the cost audit took an organized shape in the year 1959, when the Institute of Cost and Works Accounts was set up in accordance with the Cost and Works Accountant Act passed in the Parliament in the same year. However the real beginning in this direction was made only in 1965, when suitable amendments were made in the Companies Act, 1956 for the provision of the cost audit.

According to Section 209 of the Companies Act, the Union Government can direct any company engaged in production, processing, manufacturing or Mining activities to maintain cost records in a manner prescribed in the order. Section 233 states that if the Government so feels it may order an audit of the cost records maintained by the company by a Cost Accountant or a Chartered Accountant. Such an order is generally issued for the following purposes.

(i) To make a rational fixation of the selling price of products produced by monopolies, industries of national importance and essential commodities in the interest of the consumers :

(ii) To ascertain the resources of cost difference in similar products of the Units of the same industry.

(iii) To verify the accuracy of cost estimates in the case of "Cost Plus Profit Percentage" contract and for the purpose of ascertainment of tax when it relates to cost.

(iv) To divide whether to grant tariff protection to an industry on the basis of cost structure of its products.

The cost audit is conducted by a cost auditor who is appointed by the company with the prior concurrence of the Central Government. The auditor submits his report to the Central Government with a copy to the company concerned.

It would be useful to state here that even though the cost audit as well as financial audit deals with the financial aspect of all business transactions, the cost audit concentrates on only these items of financial expenditure which go to make the cost of the product, whereas the financial audit reviews all the items of expenditure appearing in the financial statement. The cost audit unlike the financial audit is not compulsory. It is done at the instance of the customers, industrial tribunal or the government. However the financial audit is done at the instance of the shareholders on the basis of the Companies Act. Another important difference between the cost audit and financial audit is that the auditor conducting the financial audit gives his opinion as to the truth and fairness of the financial statements whereas the cost auditor is mainly concerned with the propriety and efficiency of the transaction having a bearing on the cost composition of the product.

1.5.8 Management Audit :

In any form of organization the management plays an important role in the success or failure of the undertaking. It is said that a good manager can turn a bad project into a good project, whereas a bad or inefficient manager can ruin even a good project. One of the limitations of the financial audit is that it examines only the

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financial transactions and ignores the non-financial aspects like good industrial relations, goodwill, efficient and honest management etc. which are more important for the success of the business. The management audit focuses attention on the assessment of the efficiency of the management of an organization. According to William P. Leonard, "management audit is a comprehensive and constructive examination of an organization structure of a company, institution or branch of a government or of any component thereof such as a division or department and its plans and objectives, its means of operation and its use of physical and human resources".

The important objectives of management audit are as follows :

(i) To review and evaluate the actions and performance of all levels of management from top to bottom more in physical terms than in financial terms on the basis of predetermined objectives, targets, and standards.

(ii) To identify specific responsibility centres which are responsible for low productivity and profitability.

(iii) To suggest a realistic course of action and result oriented motivation system to improve the profitability and efficiency of the organization.

(iv) To review and evaluate the management techniques and other control system within the organization with the object of making them more efficient in the light of the needs of the organization and of the economy.

The management auditor is normally appointed by the owners/shareholders of the organization. However now-a-days when a number of large industrial units are approaching the government or governmental agencies for increase amount of resource either due to sickness short term financial stringency, the management audit is also directed in those organization by the government on the concerned financial institutions.

Since management is the key to success of any enterprise, the management audit, if properly conducted by qualified and experienced auditors, can serve as an excellent control device and a tool to assess management performance in the light of the pre-determined targets and established standards.

The ever changing socio-economic conditions where the Government is undertaking more and more development role by directly entering into the field of industry and business, ,the need for a management audit of the government department/concerns has assumed more importance. Necessary steps should be taken to make periodic audit of the management aspects of the Government organization to make them more efficient and productive. On the basis of the methods of examination the audit has been classified into continuous audit, periodic audit and Balance Sheet audit.

1.5.9 Continuous Audit

A continuous audit is one where the auditing staff are engaged continuously throughout the year towards examination and verification of the accounts of the business concern. The continuous engagement may mean that auditing work is done at regular intervals either monthly or bi-monthly or quarterly throughout the year. At the end of the year, the auditor checks the Profit and Loss Account and Balance Sheet and gives his own certificate. The continuous audit involves that go on to make the final accounts of the concern.

The continuous audit is most suitable in case where the final accounts are to be presented immediately after the close of the financial year as seen in the case of most of the financial institutions. In case of the organizations where the number of business transactions are very large or where the internal check system is not very sound, the continuous audit system is most suitable to verify the truth and fairness of the final statements of the affairs.

The continuous audit because of it's detailed and exhaustive system of examination of the accounts of the organization, offers some important benefits to the organization. The errors and breach are reflected after early date and the possibility of their non detection is reduced to the minimum. The continuous examination makes possible the presentation of accounts immediately after the end of the financial year. In a system of continuous audit, the auditor can plan the work systematically because of the adequate time at his disposal. The continuous audit also acts as a moral check on the staff or the client who are ever alert and up-to-date with their books, because of the continuous presence of the auditor.

In spite of all these benefits, the greatest demerit of continuous audit is the prohibitive cost it involves. Because of the continuous nature of his work, the auditor normally charges higher fees. Because of the frequent visit by the auditor, there may also be interruption in the work of the client as the auditor may requisition different books of accounts for his verifications. In the case of continuous audit, it is possible that the figures in the books of account which has already been audited by the auditor in his last visit, may be altered by a dishonest clerk and the fraud may thus be perpetrated.

1.5.10 Periodic Audit

The Periodic audit is also known as final audit or complete audit. Under this method of auditing, the audit work is taken up at close of the financial or trading period when all the accounts have been balanced and a Trading and Profit and Loss Account and Balance Sheet has been presented. In case of periodic audit, work is completed in one continuous session after the end of the year. The auditor visits the client, gets hold of all books of accounts and checks and verify all the accounts, from the beginning to the end of the year.

Since under the periodic audit, the entire audit work is done with a short period of time, it is not possible to have detailed examination of all accounting entries as were possible in case of continuous audit. It has also been seen that the auditor might have a number of clients whose financial year might be the same. In that case, the audit work of all the clients might not be finished in time. The possibility of an error or fraud being not detected is comparatively higher in case of periodic audit than in case of continuous audit.

However in spite of all these shortcomings, the periodic audit has some important advantages over continuous audit. Under the periodic audit it is very difficult to tamper the figures, because the audit work is completed in one sitting of the auditor. The audit needs to maintain a big establishment for the purpose of auditin work. In the small organization, where the number of transactions are not very larg the periodic audit can be suitably and safely employed, so that there will be les audit fees, no dislocation in day-to-day work of the staff and there would not be an frequent alternation among the audit staff maintaining the accounts.

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1.5.11 Balance Sheet Audit :

The balance sheet audit is of recent origin in the field of auditing and foun more popularity in some of the advanced countries like U.S.A. and Canada. Unde the balance sheet audit, the audit is concerned only with the items appearing in the balance sheet such as capital, reserves and the assets of the business.

Under the traditional system of auditing, the audit work starts with the books o primary entry and following the sequence of the order in which the entries are made ends with the Balance Sheet. This procedure of audit can be satisfactorily applied in case of small and medium sized organizations where the volume of transactions are not great. However, in case of large enterprises, where mechanized accounting system or automation of records is adopted, which ensures arithmetic accuracy of the accounts, a detailed audit is quite unproductive, unnecessary and expensive. The existence of adequate and sophisticated systems of internal control make the exhaustive checking of the entries less important and enormous volume of transactions make it impossible to complete the audit-work in a reasonable time, if a detailed examination is made all the entries in the books of accounts.

Under the balance sheet audit, greater emphasis is laid on the verification of the assets and liabilities appearing in the balance sheet and only secondary importance is given to the examination of the other entries and voucher. However it may be stated here that even though the balance sheet audit concentrates on all items of the Balance Sheet, it cannot completely neglect the owner of the business operations. Since the balance of the Profit and Loss Account appears on the Balance Sheet, the audit will have to review the transactions recorded in the Profit and Loss Account. In this way, the Balance Sheet audit assumes some character of an annual audit.

SELF TEST – 2

1. What is Auditing ? How many types of audit are there ? Explain.
2. What is Government Audit ? Give the details of Government Audit.
3. Distinguish between Internal Audit and Internal Check system.
4. What is interim audit ? What are the benefits of Interim Audit ?
5. Write short notes on :
   - (i) Performance Audit.
   - (ii) Cost Audit.
   - (iii) Independence Audit.

1.6 COMMENCEMENT OF A NEW AUDIT

An auditor is primarily appointed to examinee the transactions recorded in the books of account. The transactions take place under particular situations, carried out and recorded by a particular set of people, recorded in a particular manner. Therefore a knowledge of the nature of the business, the situation in which the transactions have been made and recorded and the manner of reading have a relevance to the examination of the transactions. Before commencement of the examination of the books of account in which the transactions have been recorded it is advisable for the auditor to gain a knowledge about the situation of the business undertaking.

On undertaking a new audit, the first task of the auditor should be to see that his appointment is in order. Then he should try to ascertain the precise nature and scope of his duties. In case of an audit under stature, i.e. Company audit, this question does not arise as his powers and duties have been clearly defined in the stature. But in other cases, i.e. Sole traders, partnership firms, etc. the line between accountancy work and audit work proper, however, is some times so uncertain in the minds of clients that it is advisable for the auditor to ascertain exactly what his client requires, and to take care that this is formulated in writing, especially were the audit is not to be a complete one. Otherwise, the auditor will, later on, be held liable for which was never entrusted to him and which he never performed and he will find himself in a fenceless position. Therefore, in other words, if he is engaged to do some accounting work, this should be specifically stated in the agreement listing the specific accountancy services to be undertake by him.

At obtaining this information the next step should be to ascertain the precise nature of the business carried on by his client and the situation in which it is transacted. He should try to familiarize with the peculiar nature of the business and its technical details so that he may be able to put intelligent questions to his client staff. He should know the exact nature and type of goods dealt with or produced, the different raw materials and the output of finished goods, the mode of transportation of the raw material to different work sops, the location of the stores, the manner of storing the goods and its easy accessibility, the average number of workers employed in the workshop etc. He should do well to go to the factory or workshop and gain a first hand knowledge on these things. If there are any technical features with which he is not familiar and which calls for elucidation, he should obtain information and acquaint himself with them without hesitation even by discussing things with the workers, as no audit can be thorough and effective, unless the auditor has grasped the peculiar nature of business and the meaning of the transactions recorded. He should select representative transactions of each class to go through in order to intimately acquaint himself with the procedure and acquire the necessary knowledge.

The auditor should then make a careful examination of the system of accounting employed. Where there is a definite system of internal check in operation, the auditor should ask for a written statement regarding it as he has to depend on it in deciding the extent of detail checking to be done. He should study these systems and find out their strength and weaknesses with a view to determining the ground to be covered by his investigations and to decide for himself to what extent he can safely rely on the internal check already existing and limit the extent of his detailed checking. If he finds any weak spots in the system of account-keeping or in the system of internal check in existence, he should, of course, devote special attention to these and should seek to remedy the existing defects by recommendations.

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He should next obtain a complete list of all books used in the concern to ensure that no book escapes his examination and that later on he is not made liable for not examining a book the existence of which was not known to him. The names of the principal officials should be obtained, together with particulars of the work controlled by each, the scope of their authority and their specimen signatures. This will facilitate in sending for the particular official to explain a transaction for which he was responsible and avoid unnecessary calling for officials who are not connected with the transaction.

It would be equally necessary for him to make a careful study of the documents which would form the very foundation of his work, such as the Partnership Deed in the case of a Partnership Audit, the Memorandum and Articles of Association in the case of a company audit, the Will or the Trust Deed in the case of a Trust Audit, etc. and take notes of relevant clauses. If the accounts have been subject to prior audit, the late auditor's report or internal audit report, if any, should be seen, as it may contain material information relevant to audit, and, if possible, personal discussions with the late auditor should be arranged to know the reasons of his removal and any weaknesses in the organization.

From a first general examination of the books, in conjunction with the above information, the auditor will be in a position to formulate the principal lines on which the audit must be conducted, and the direction of these will be determined by his appraisal of the efficacy or otherwise of the system of internal check. He should devote more attention to the examination of the transactions over which the system of internal check is a weak one or where it leaves gaps or loopholes.

The closing balance sheet of the previous year will be examined by the auditor, the whole of the balance comprised in it should be checked in order to make certain that the period now under review commenced with the balances shown there in or that the closing balances of the previous year have been correctly shown as the opening balance of the year under examination.

If the auditor is appointed in the place of another auditor, before accepting the appointment, enquiry should be made as to the reason for the change, and the retiring auditor should be communicated with, to ascertain whether there is any professional reason for which the audit should not be accepted. The Professional Codes of Conduct require that the auditor cannot accept an appointment without taking the consent of the retiring or removed auditor.

Not infrequently, he would find that the additions of Ledger Accounts and the balances brought down are in pencil : or it may be that the accounts are not balanced and the balances are not brought down. Under such circumstances he should ask the client's staff to write all additions and balances in ink, to balance the books and prepare the final accounts and Balance Sheet, to file the vouchers in separate files in order of occurrence of the transactions, to prepare the schedules of debtors and creditors and of investments and to properly arrange legal papers, contracts, etc. necessary for the purpose of the audit. He should also see that a separate and well lit room has been arranged for the purpose of his audit where he can keep his papers and conduct the audit.

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1.7 AUDIT PROGRAMME

After familiarizing himself with the whole circumstances of the business, the auditor will be in a position to make an exhaustive list of the works to be performed during the audit, to formulate the order and the principal lines on which the audit must be conducted, that is where detailed checking is to be done and where test checking may be applied. This will depend on the nature and effectiveness of the system of internal check. He will assign each work to particular audit clerk taking into account the existence, knowledge and skill of the clerk concerned and allot definite time for the completion of each work. The clerk concerned should put his signature on it signifying the undertaking of the responsibility by him. This plan of work is known as Audit Programme and is prepared in a columnar form. Full particulars should be recorded as to the periods selected for tests, the date when the work done and the time it took to perform. The clerk responsible for each portion of the work, after making the necessary entries should put his signature as the work is performed.

On the occasion of the first audit it is not advisable to draw up a hard-and-fast programme as the work to be done can really only be decided on as the audit proceeds. Careful note should, however, be taken of the work performed and this will afford material for the preparation of an audit programme to be followed in the future.

The Audit Programme comes in very useful for the purpose of supervising the work of the auditing staff and finishing the work in time. Further, it enables the Auditor or his responsible clerk to ascertain at any time, what portion of the work has been done, by whom it has been done and what remains to be done to complete the audit. It helps to maintain continuity of work even in the absence of an audit clerk. It is most important for a busy auditor having large number of engagements to control the staff and to fix up responsibility.

1.7.1 Advantages

The following are the advantages of a well drawn-out Audit programme:-

1. By providing an exhaustive list of the works to be done and by dividing the work amongst the audit staff, an Audit programme ensures uniformity in the distribution and performance of work and makes certain that all the work is done which should be done and that nothing has been omitted or left out.
2. In a properly organized audit office, it is essential that the principles should be perfectly familiar with the work performed on each audit. But a busy auditor, who undertakes the audit of several firms at a time, does not get time to go

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into details of each audit. The Audit Programme provides him with a means to immediately ascertain the progress of each audit by taking a bird's eye-view of the Audit Programme. From the programme he can know what portion of the work has been done and what remains to be done to complete the audit. If he finds that the remaining time is not adequate to complete the audit, he will either request the client to allow him more time or modify the programme so as to complete the work in time. Thus he can exercise effective supervision over his staff and effectively supervise the work conducted at several concerns.

3. The Audit programme ensures the completion of the audit work in time. In the event of an audit clerk-in-charge being away or leaving the firm, no difficulty will be experienced in carrying on that particular matter by another clerk. From the Audit Programme the point where the work has been left by the previous clerk can be ascertained and the new clerk will resume work from that point. Thus continuity of work can be maintained.

4. As definite work is allocated to each clerk and his signature obtained as proof of the same, in the event of work being left undone or errors being passed or made or frauds being not detected, the responsibility can be fixed on the clerk concerned. Thus the Auditor will be able to defend himself against any negligence or wrong committed by his staff.

5. It provides a definite documentary record of the works done by the Auditor in the Audit. In case of dispute or a charge of negligence against him, the Auditor can defend himself by showing the Audit Programme what work he had exactly covered up and will not be liable for the work which he was never asked to do.

6. It provides a definite guideline to the audit clerks, particularly the new clerks. They can know what definite work they have to perform and how and within what time to perform. They will try to stick to the programme which will increase their efficiency.

7. It provides a useful basis for preparing future audit programmes for the same concern and for other concerns.

1.7.2 Precautions

Some firms employ a standard form of audit programme to be used in all cases. Such a practice is, however, undesirable as it discourages initiative on the part of the auditing staff and make them lose their sense of responsibility. Besides, no two audits, even in the same line of trade, would present the same problems to solve. Therefore, audit programme of one year may not be suitable in the next year. Moreover, in order to make the audit effective, the order in which the work is to be performed must be changed from year to year and concern to concern. In other words, no two audit programmes should be alike. Consequently, in order that the audit may be done efficiently, it is highly necessary that the exact scheme of work should be drafted, after carefully considering the particular requirements of each case. Each Audit Programme should be tailor-made.

Great care, however, must be taken to ensure that the programme does not become obsolete. With a view to preventing the audit work from being stereotyped or mechanical or too automatic in its nature, and the initiative of the clerk-in-charge becoming stifled or lost to large extent, the clerks including the junior clerk, should be encouraged to make suggestions for amending the programme in order to bring about improvements in the plan of work from time to time as they may deem desirable and to make surprise checks outside the programme. Their suggestions should be accepted whenever it is found reasonable. It should be impressed upon the audit clerk that the Audit Programme is only a guidance and not a rigid one. The audit programme should be made a flexible one, and be revised and modified from time to time and made up-to-date in the light of the experiences gained and the changes made in the business, The same scheme of work should not be followed for two successive periods. The programme should be varied by the Auditor and brought up-to-date after a fresh study of requirements from time to time basing on experience and changing circumstances.

1.8 AUDIT NOTE BOOK AND WORKING PAPERS

Prior to the commencement of audit and during the progress of the audit, apart from the Audit Programme, an auditor has to make several notes relating to and for the purpose of the Audit in order to facilitate writing of the report at the end to keep a convenient record of the work done to be used in future for his defence. These notes should be hand written and should be kept in a manner so as to be capable of being preserved for a long time. Separate audit notes are made for each concern. It is advisable to keep these notes in a small bound book in the nature of a diary. The book in which the auditor makes the notes is known as Audit Not Book or Audit Memoranda. Most of the notes taken down in the Audit Note Book are of importance for a single audit and may not be required for the next audit. But some of the notes are for permanent importance for the auditor and may have to be referred to at every audit. The Audit or should, therefore, do well to maintain two Audit Note Books for each concern, They are : (1) Permanent Audit Note Book; (2) Annual Audit Note Book. Matters of permanent importance which have to be referred to at every audit are noted down in the permanent Audit Note Book. They are :

Names of the Principal Officers and their responsibilities ;

Technical terms used in the business;

Accounting method followed in the business;

System of internal check in operation;

Provision in the Partnership Deed, or Trust Deed or memorandum and Articles of provision of debenture bonds and important contracts testing over a number of years.

Association affecting the accounts and Audit;

Points of importance also, which require to be remembered from one audit to another, but which are not apparent on the face of the accounts, should be recorded.

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On the occasion of the first audit of a business which is of technical nature, and where special consideration apply, it is very convenient to make explanatory notes of all transactions of technical difficulty, so that these can be referred to by other who may have to take up the work subsequently.

The Permanent Audit Note Book disoenses with the need for referring to the original basic documents and rules on the occasion of every audit. The Auditor should only go through the Audit Note Book and thus save his time and labour.

On the other hand, the Annual Audit Note-Book records only matters of importance for the work done, various questions raised in the course of the audit, and the explanations, information and instruction received from those management. Usually, the following matters are recorded in this book -

The points which required further explanation and clarification;

- The particulars of the missing vouchers, the duplicates of which have to be obtained;
- The mistakes and errors discovered and adjusted;
- Totals of balances of certain books of account;
- Bank Reconciliation Statement;
- Various questions raised in the course of the audit, and the explanation, information and instructions received;
- All important things that call for discussion with the client,
- Such other matter as may prove material;
- Audit Report

Care should be taken not to overload the notes by entering therein insignificant errors and queries. It is preferable to clear up a query and get rid of it, than to make a note of it. Those points, however which cannot immediately be cleared up must be noted. A new note book should be opened for every audit. This book may be of great help to the auditor in preparing his audit report. It might prove a great value later on, in case a suit is filed against him for negligence, it will be a documentary evidence in favour of the auditor even after several years by which time the auditor might have forgotten everything relating to that particular audit. The importance of such a Note book was emphasized in the London and General Bank case.

Besides the Audit Programme and the Audit Note Books, the appointment letter of the Auditor containing the terms of his appointment, his correspondence with the client and the previous auditor, schedule of debtors and creditors, replies received from debtors and creditors various written statements obtained from the persons in Management, the draft Trial Balance, Profit & Loss Account and Balance Sheet used by the Auditor for the purpose of the audit are also important documents. All the above documents are referred to as working papers. The audit notes as also the working papers prove to be of considerable help when anything goes wrong and the auditor is called upon to explain and defend his position. It may be that the trouble arises some years after the work was performance and if the auditor has no such record, indicating what work he performed, what queries he raised and how and by whom they were explained he would surely find himself in a most unenviable position. In the case of Apfel Vs. Awnan Dexter Co. the case arose after 30 years of performance of the work by the auditor and fortunately, the auditor had carefully preserved all the working papers with the help of which he defended himself and was acquitted. This emphasizes proper preservation of all the working papers for a long time.

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SELF TEST – 3

1. What preliminary precautions must be followed before the commencement of a new audit ?
2. What is an Audit Programme ? Discuss the advantages of a we drawn out Audit Programme.
3. What are the objectives of an Audit Programme ? What precautions should you take in drawing up and working out an Audit Programme ?
4. What is an Audit Note Book ? what are its contents?

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UNIT – II INTERNAL CHECK SYSTEM

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  2.8.7 Bills Receivable
  2.8.8 Commission
  2.8.9 Sale of Investments
  2.8.10 Sale of Fixed Assets
2.9 Vouching
2.10 Vouching of Trading Transactions
2.11 Vouching of Impersonal Ledgers
2.12 Verification of Reserves and Provisions
2.13 Valuation of Fixed Assets

2.0 OBJECTIVES

After going through this lesion you will be able to

- Understand the internal Control
- Define the Internal Check
- Know What is Vouching and its transactions.

NOTES

2.1 INTRODUCTION

In auditing you often come across the three terminologies and at times it creels confusion as to the examining of each of them, it is essential that the exact meanings, scope and objects of these three terminologies should be properly understood. This should not be used indiscriminate.

2.2 INTERNAL CONTROL

Internal control best regarded as an indication of the whole system of controls; financial and otherwise, established by management in the conduct of a business including internal check, internal audit and forms of control.

The most important definition of internal control published by the committee of Auditors of the CPA in 1949 state that "Internal control comprises the plan of organization and all of the co-ordinated method measures adopted within a business to safeguard its assets, check the accuracy and relay of the accounting data, promote operational efficiency and encourage adherence to prescribe managerial policies to attain the objects. "Such a system might include budgetary control, standard costs, periodic operating reports, statistical analysis and to disseminate there of gaining programme designed to help employees in meeting their responsibilities and internal audit staff to provide additional assurance to the management as to the adequacy outlines, procedures and the extent to which they are being effectively carried out.

It would thus state that internal control is much broader term and includes within its scope not only internal check and internal audit but all other forms of control introduced for the efficient working of a concern. It pervades the entire organization and covers up, financial and non financial, technical and non-technical transactions in the organization.

The characteristics of a satisfactory system of internal control would include:

1. All the responsibilities of the organization should be divided into a certain number of function and the functions should be appropriately segregated from each other.
2. Persons should be authorized to carry out each function and record procedures should be adequate to have reasonable control over assets, liabilities, revenues and expenses; the record procedures should be devised as to record all incoming and outgoings of assets, liabilities, incomes and exports.
3. Sound practices should be followed in the performance of duties and functions of each organizational department.
4. There should be a degree of equality of personnel for each function commensurate with responsibilities.

5. No department should keep the final control records of the functions and activities for which the department is responsible. For example, the cashier should have no access to the ledger accounts.

2.3 INTERNAL CHECK

NOTES

Internal check was defined in a bulletin of the American Institute of Accounts in 1936 as "Those measures ;and methods adopted within the organization itself to safeguard the cash and other assets of the organization as well as to check the clerical accuracy of the book-keeping". In the narrow sense Internal Checks are 'measure and methods" burst into an accounting system to check the accuracy of accounting and safeguard the assets of the concern. In the broader sense, Internal checks and accounting controls include the plan of organization itself and control devices other than those later are purely book-keeping. It does not, in fact, constitute a distinct system, but provides rather measures and methods that are an integral part of a procedure i.e. part of a system, without involving employment of additional personnel.

Internal Check is best regarded as indicating the checks on the day-to-day transactions which operate continuously as part of the routine system, whereby the work of one person is checked independently or is complementary to the work by another, the object being the prevention of the early detection of errors and frauds. Internal check is a method of organizing the entire operations of office, factory and warehouse, and the duties of the respective staff in such a manner that fraud and irregularities are almost impossible without collusion between two or more persons and that errors and irregularities shall be capable of immediate detection by the automatic operation of the system. It involves a subdivision of duties amongst the existing employees in such a way that no one person is allowed to carry through and to record every aspect of a transaction, but at some stage in its performance each person's work thereon comes to the notice of at least another person. It is thus very difficult for fraud to be perpetrated without collusion between the members of the staff concerned, where there is an efficient system of internal check. It is a kind of division of labour amongst the existing employees without employing additional staff and associating as many employees as possible with the performance of each transaction. Each transaction should pass through at least two hands and each of them should perform his part independently. It also involves introduction of "measures and methods" or procedures into the system. For example, in the case of receipt of cash from customers the cashier should receive it, the ledger clerk should record it in the personal A/c of the customer and a third employee shall send the receipt to the customer, each performing his duties independently so that errors committed by one can easily be detected by the other immediately.

Internal Check, therefore, includes such matter as the allocation of authorities, the division of work amongst existing employees and defining each employee's responsibilities, the proper method of recording transactions and the use of independently ascertained totals against which a large number of individual entries can be checked such as a Sales Ledger Control Account or Self-balancing Ledger System. Internal checks do not make frauds impossible by any means, but why make it more difficult, and the chances of detection much greater, and therefore, ac as a valuable moral check. It also makes sure that all facts and transactions that affect the financial position of the undertaking are duly, accurately and promptly recorded in the books of account. When considering or advising on the installation of a system of Internal Check, the auditor should bear in mind the essentially practical nature of the problem.

NOTES

In devising any system of internal check, there are three matters to be specially borne in mind; first the person in charge to the cash should never be in charge of any ledger or at least of any trade Ledger; secondly each separate Ledger should be made self-balancing, or at least should be arranged that it can be balanced separately; and where this is for any reason, not altogether practicable, it is absolutely essential that those Ledgers which are not checked in detail should be so arranged that they may be collectively, balanced separately from those ledgers that are; ;thirdly, where the trade Ledgers are numerous and are not checked in detail by the auditor, the clerks in charge should be changed about frequently, so that if there be any irregularity it may be impossible for it to remain long undetected without implicating the whole staff.

2.4 INTERNAL AUDIT

Large undertakings commonly have an internal audit department under the control of the Chief Accountant but independent audit throughout the year. This Internal audit is in complementary to professional audit.

Internal Check should not be confused with internal audit, for the latter implies a separate staff, who may or may not have professional audit qualifications engaged on continuous audit work, in addition to the customary professional audit. Although in large concerns the Internal Audit Department may be an integral part of the system of Internal Check, it is only a part, and should not, therefore, be confused with the whole system which may operate without it. A system of internal check is designed to prevent fraud, whereas the labours of an internal auditor are directed towards detecting fraud. The two are independent of each other though there is a great deal of similarity in the functions of the two system.

An internal audit is a review of operations and records, sometimes continuous, undertaken within a business by specially assigned staff. The scope and objectives of internal audit vary widely in different business and may particularly in large organizations extend to any matters, which are not directly of an accounting nature. On accounting mattes the main objective of an internal audit is to assure management that the internal check and the accounting system are effective in design and operation. In practice, the internal auditor may often be required to report also on whether the system of accounting and the internal check are economical. Internal audit is the part of the whole system of internal control, but is not an integral part of the internal check or the accounting system. Two essential features of an internal audit are that it should operate independently of the internal check and that in no circumstances should it divert any one of the responsibilities placed upon him.

On accounting matters, the functions of the internal auditor are largely the same as those of the statutory auditor and he has to ascertain that there is (a) an effective system of internal check to prevent or detect errors and frauds and that is operating satisfactorily (b) an adequate accounting system to provide the information necessary for preparing true and fair statements. The work of both the internal auditor and the statutory auditor, on accounting matters, is carried out largely by similar means, such as :

(a) examination of the system of internal check for both soundness of principle and effectiveness in operation;

(b) examination and checking for accounting records and statements;

(c) verification of assets and liabilities;

(d) observation, enquiry, the making of statistical comparisons and such other measures as may be judged necessary.

Although the two forms of audit have a common interest in the important matters mentioned above there are some fundamental differences :

2.4.1 (a) Scope :

The extent of the work undertaken by the internal auditor is determined by the management whereas that of the statutory auditor arises from the responsibilities placed on him by statue.

It is not part of the duty of a statutory auditor to give suggestions on any matters unless specifically asked for to do so. But an internal auditor, apart from examining the books of account and helping in the preparation to final accounts and Balance Sheets, helps the management is many non-accounting matters. He has to ensure the existence and effectiveness of a good system of internal check and a sound accounting system, to ensure the adequacy of the procedures outlined by the management and the extent to which they are being effectively carried out, to help the management in matters of budgetary control, standard costs, periodic operation reports necessary for taking correct policy decisions, statistical analysis to find out the weak sports in management and to remove them, arrangement of training programmes for the employees, etc. He helps in elimination of wastages and losses of all kinds and inefficiency in carrying out operations and ensures adherence to prescribed managerial policies, i.e. plans and estimates, to attain the objectives of the organization. In other words he acts as an important part and parcel of the management. Those non-accounting functions of the internal auditor i.e. management audit is outside the scope of statutory audit. The internal auditor acts as the watch-dog of the management.

2.4.2 (b) Approach :

The internal auditor's approach is with a view to ensuring that the accounting system is efficient, so that the accounting information presented to management throughout the period is accurate and discloses material facts. The statutory auditor's approach, however, is governed by his duty to satisfy himself that the accounts to be presented to the share-holders show a true and fair view of the profit or loss for the financial period and of the state of the company's affairs at the end of the period.

2.4.3 (c) Responsibility :

The internal auditor's responsibility is due to the management, whereas the statutory auditor is responsible directly to the share-holders. It follows that the internal auditor being a servant of the company, does not have the independence of status which the statutory auditor possesses.

NOTES

2.4.4 (d) Qualifications :

The internal auditor may or may not possess professional qualification and may not be a member of the Institute of Chartered Accountants of India, whereas the statutory auditor must be a Chartered Accountant within the meaning of the Chartered Accountants of India Act, 1949.

2.5 THE AUDITOR AND THE INTERNAL CHECK & INTERNAL AUDIT

In a large business, where there is a staff of some members engaged upon the books, it is quite a simple matter to organize a system of internal check that may relieve the auditor of a considerable amount of detail checking and thus limit his investigation behind the books themselves to occasional tests. Also large undertakings commonly have an internal audit department which carries out a continuous audit through out the year and the internal audit is complementary to the professional audit. It has to be remembered terminal checks are having no guarantee against fraud, they merely reduce the chances occurrence of errors and frauds and enhance the chances of their detection. The question therefore, is to what extent should an auditor rely upon the system of internal check and in audit in operation and limit the areas of his investigation ?

Where the business is a small one, the book-keeper has generally control over the books of accounts and anything like an internal check is lacking, it ill necessary for the auditor to verify the whole of the transactions with the original recorded call the whole of the postings, check all the costs, and tally the books. Even in case of a large business, where the books have not been properly maintained and not agreed and there is tack of efficient control even if a system of internal check is in operation, the auditor must necessary check a substantial portion of the transactions, if not the whole due to want of time. In a large business, however, where the auditor finds a sound system of internal check being arranged , he need not necessarily examine all the entries. He can in that case do away with a considerable amount of detailed checking by curtailing ticking and casting, and restrict the rest of the work to certain periods he may select. If in the course of those tests no irregularities are closed, he may safely take it that the rest of the work is equally correct. On the other hand each tests indicate the existence of several errors at lead to the slightest suspicion of fraud must necessarily extend the scope of his investigation and if necessary, must check everyday.

The soundness of the system of Internal Check and the manner in which it is carried out are, therefore, matters of fundamental importance to the auditor. These are determined to a large extent the amount of examination of detail which the auditor consider it necessary to undertake. The Auditor should examine the whole system of internal control before embarking on the routine work of the audit and satisfy himself that his system has been actually carried out as originally designed, and sections of the work should be fully at unexpected times. He should pay special attention to any weak points in the system by checking here and there haphazard at random. His endeavour should be to see the system is such that every transaction is properly recorded in the financials lots, that there is no possibility of items being omitted or altered purposely or accidentally and that no fraudulent entries can be made). If the system stands the test and prove to be an efferent one, an auditor may relay there upon to a considerable extent as regards a large part of the audit work and thus will have more time to devote his attention to the more important parts of the audit. If the system is weak, the auditor has to be forced to spend much valuable time of matters of relatively minor importance, by undertaking a more thorough check in every direction where any discrepancy might have arisen. If the system is so bad that no reliance are to be placed upon it by the Auditor, then the whole of the transactions must be checked, regardless of the apparent system of internal check in force. The Auditor must decide for himself the extent to which he feels justification upon any particular system.

It should be borne in mind that the internal check however sound, only reduce the chances of fraud does not altogether eliminate it and that it may reduce the volume of detail check to be done by the auditor but does not reduce his responsibility and liability. The judgment of auditor shall depend on his skill, intelligence and experience and the nature of basis of the system of accounting, the reputation of the employees for their integrity, the system of internal check and the manner in which is being carried the circumstances of the particular case. He should be careful not merely to rely on these laid down for internal control, but satisfy himself by due enquiry that they are rigidly forced.

Since where the auditor is satisfied that the internal auditor has adequate covered the part of which would otherwise do, he may be able to reduce the extent of his examination detail. He may be able to rely to a large extent on the internal audit in determining whether system of internal check is operating satisfactorily and is assessing the general reliability accounting records. He may also derive much assistance from the internal auditor's knowledge of the accounting system and technical knowledge of the business particular in connection with stocks in-trade, the physical existence of fixed assets, depreciation charges, ascertainment of liabilities and the risks of fraud or misappropriation. He should, therefore examine the internal audit programme and reports in order to see what ground has been covered what parts have arisen, how they have been dealt with and generally to satisfy himself the internal audit has been thorough and efficient. It is for the auditor to decide whether at what extent consistently with his statutory responsibilities, he can rely on the work of internal auditor in order to reduce the extent of his own examination in detail. His decision depends on his judgment on the facts of each case, having regard in particular to :

(a) Extent and efficiency of the internal audit in order to assess these matters, he should examine the internal audit programmes, working papers and reports and such tests as he thinks fit for the work done by the internal auditor.

(b) The experience and qualifications of the Chief Internal Auditor and his staff

(c) Authority interested in the chief internal auditor and the level of management to which indirectly responsible.

The auditor cannot in any circumstances divert himself of the responsibilities laid on him.

2.6 TEST CHECK

NOTES

In a large business, it may not be possible on the pat of the audit to do a detailed checking of all the transactions within the limited time allowed to him to core late the audit and give the report. In such a case, he usually does away with a considerable count of detailed checking by curtailing ticking and casting and restricts the routine. In work certain periods he may select haphazard at random, and thus will have more time to devote attention to the more important parts of the audit, such as verification and valuation of assess and liabilities. If in the course of the examination of these selected transactions no irregularities are disclosed, he takes it for granted that the rest of the work is equally correct. This method of investigation is known as 'Test Checking' and now-a-days has become a common method.

There are occasions where such short-cuts may be restored without incurring any risks. For instance where there happen to be several properties and the Rent Rolls have been properly maintained, the auditor may satisfy himself as to the correctness of the total rents shown as received in the financial ledger by reconciling the fact with the results as indicated by the Rent Rolls or the Tenants Registers in the following way. To the total rents receivable during the period under audit as ascertained from the Rent Rolls the arrear of rent brought over from the previous year should be added. If the total of the rent remaining unpaid at the close of the current period, as arrived at from the Rent Rolls is deducted from the above, the balance must represent the rents actually received during the period as shown by the rent A/c in the financial ledger. This will of course be subject to any rents that may have been written off as bad and irrecoverable under proper authority where the Rent Rolls; or Rent Registers are maintained on a sound and reliable basis the auditor can thus save himself from necessary trouble of checking every entry in respect of rents. As a precautionary measure, however, he may supplement this work by a detailed checking of the rent bills. Rent Roll the cash book and the Rent A/c for any odd period he likes, say two or three months so as to satisfy himself as to the correctness of the records. He would however, open himself to serious risks if he tries to apply such test checks in a business where there is lack of proper organization or control, and absence of any effective system of internal check.

'Test Check' undoubtedly reduces the work of the auditor, but does not reduce his liability, rather it increases his risks. He cannot escape liability for negligence on duties by merely stating that he adopted 'test checking' and the particular transaction through which fraud had been perpetrated had not been examined by him. He must therefore, be careful in adopting shortcuts.

To the intelligent auditor, who has grasped his system thoroughly it is generally practicable to dispense with remembering portion of mechanized checking. To what extent this can be done with safely must always remain a question for each auditor's

own intelligence and experience to answer, and it may be added that probably h
must take the risk of any consequence that may arise.

NOTES

In deciding upon the portion of the entries to be examined as tests, the audito
should find out in what sections there is any likelihood of an irregularity or a seriou
discrepancy existing. For instance, if on enquiry he finds that the handling an
recording of cash receipts and payments is subjected to a sound control, but th
incomings and outgoings of goods have not been proper attended to, he shoul
most minutely scrutinize the original voucher and records relating purchases an
sale, and restrict the checking of the record of cash receipts and payments a la
percentage of tests.

For test checking transactions should be selected here and there, haphazar
at random. Care must be then to see that they are representative transaction
Transactions should be so selected as to cover transactions of every descriptio
i.e. of different nature, of every season of the year (but season as well as slac
season), of every account, of every book and of every employee. A large number
entries of the first and the last month of the year should be checked. In no case te
check should be applied on the cash book. The method of selection of transactio
for test checking should vary from year to year.

SELF TEST – 4

1. What is Internal Check ? What are its objectives ?
2. What is Internal Control ? Is it different from Internal Check ? If so, in wh
ways?
3. What are the difference between internal auditor and statutory auditor ?
4. How does the systems of Internal check and Internal Audit help n auditor
When can an auditor rely upon these systems? What precautions should h
take before relying upon these systems?
5. What do you understand by 'Test Checks'? State the circumstances und
which test checking to be done safely. What precautions should the audit
take before resorting to shortcut.
6. What do you understand by 'Working Papers'? Describe the importance
proper preservation of records and working papers by an audit citing cas
examples.
7. What general steps would you suggest to make an internal check syste
effective ?

2.7 AUDIT OF CASH TRANSACTIONS

The Cash Book is considered to be the most important of all the subsidia
Books. All the transactions of a business ultimately become cash transactions a
find a place in the Cash Book and secondly, cash is the easiest of all the assets
misappropriation. Therefore, the examination of the Cash Book is usually taken
first by a audit or in almost all cases. The objectives of vouching the Cash Book a
to ensure:

1. That all receipts and payments are duly accounted for :
2. That all such receipts and payments are entered under their appropriate heads of accounts;
3. That all payments are made for some benefits received by the concern and that no unauthorized or fraudulent payment is made;
4. The closing cash and bank balances are correctly arrived at and that the actual balances in hand are in agreement with the balances thus arrived at.

NOTES

Before commencing the audit of the cash transactions of a business, it is most important that the auditor should make himself familiar with the system of internal check in operations on all kinds of cash transactions, receipts and payments since majority of frauds arise directly in connection with cash.

The duties of the cashier must be ascertained particularly as to whether he is in charge of any ledgers or books of original prime entry other than the cash book. If the cashier has access to ledger books or other subsidiary books he can easily omit a few receipts or enter few fraudulent payments and misappropriate cash. In large concerns usually the cashier is kept confined to the cash book and this is facilitated by the large number of employees. But in a small business, where the number of employees is very limited a wide division of work may not be possible and the cashier may have to be kept in charge of other books of account in addition to the cash Book. In such cases, the opportunities for the concealment of fraud by the cashier are considerably large. The auditor should also ascertain if the cashier performs any transaction other than maintenance of the Cash Book. In such cases he should be extremely careful.

Vouching the Receipts side of the Cash Book

Receipts occurring on the left hand side of the Cash Book, as they do, naturally first receive the attention of the auditor. Vouching of receipts is more difficult than the vouching of payments, since only indirect evidence can, as a rule, be obtained.

The system of internal check should be carefully enquired into by the auditor, and he should direct special attention to any part he considers weak or inadequate. In order to ascertain that the system is properly carried out, he should test each portion of the check in operation and if discrepancies are found he should carry his examination further, if the transactions he has examined are in order and do not give rise to any suspicion he is entitled to assume that the remaining transactions can be safely passed. The auditor should ascertain if the daily Cash Receipts are first recorded from day to day in a Cash Diary. If this is so, he should check the daily totals of such Cash Diary and compare the record therein with the entries in the Cash Book. On the other hand, if a rough cash Book is maintained, such a book should be tested exhaustively with the Cash Book proper to make sure that the entries in the two books are identical and that the daily or periodical balances tally. If amounts received are entered in the rough Cash Book but misappropriated by the cashier and not entered in the Cash Book proper, the auditor might be held liable if he failed to detect the fraud to his omission to examine the records available as was held in the case 'Pendlebury' ltd. Vs Ellis Green Co. (1936).

The auditor should enquire what rule, if any, exists as to the depositing of dail cash receipts into the bank account, and whether the same has been strictly adhere to. The clerk responsible for taking money to the bank should not have any connectio with other cash transactions.

NOTES

It should be noted that a loose system of acknowledging money received alway gives scope for fraud. It is, of course, impossible to eradicate it entirely in all chance of fraud, but much may be done. A special form of counter foil Receipt Book shoul be used to acknowledge every receipt. The receipts should be printed wit consecutive numbers. A receipt should be given from this book for every single iter of cash received by somebody other than the cashier and the serial number of suc receipt should be entered in the Cash Book against each entry, in a special colum provided for the purpose for ready reference. Such a method facilitates referenc and renders the auditor's work easy. In any case, where there is an adequate intern organization in regard to cash transactions, the auditor must feel considerably relive that there would not be much chance for extensive leakage in this direction. Th dates of the counterfoils should always be compared with the Cash Book entries prevent temporary misappropriation of receipts. Where practicable, it is n desirable that the clerk who writes up the Cash Book, should not be the one wh receives the money or acknowledges the receipt. He should note the dates ar other particulars correctly. The receipt for two accounts paid together should b acknowledged on two separate forms. Defalcations have frequently arisen remained undetected from a neglect of this precaution. Dividends and compositior in Bankruptcies etc. will inevitably be accompanied by a specific form or receipt.

Some firms follow the practice of sending out, along with the cheques the specially printed Receipt Forms for acknowledgements and return by the payee In such a case, it is highly desirable that the firm receiving the remittance shou also send its own receipt preferably from a Counterfoil receipt Book and marke "Confirmatory Receipt', giving reference to the cheque. This will present the receivi from omitting to account for any of such receipts.

Where Counterfoil Receipt books are used for acknowledging all amour received, the following points should be borne in mind while vouching :-

(1) That all unused books are kept 'under lock and key' and the issuing of ne books is controlled by some responsible official. No new book should be issu before the book under use is completely exhausted to prevent a few unus forms being left out in one book and later on and to misappropriate sor receipts. Before issue the Book should be certified as to the number of forr it contains.

(2) That the dates, amounts, serial numbers of the receipts and names of t remitter on the counterfoils agree with the entries in the cash book.

(3) That spoilt receipt forms are not destroyed, but are attached to the counterfo and initialed as cancelled by some one in authority. Similarly both the parts the cancelled receipts should be there and if any forms has been left out unuse the same should be cancelled to prevent any fraudulent use.

(4) That the forms are consecutively numbered and no number is missing. The receipt form and the counterfoil should bear the same number.

(5) That the discounts allowed to debtors and customers accord with the usual terms of credit. In case discount has been allowed at a special rate the same should be sanctioned by duly authorized officials.

NOTES

The important sources from which cash is received are :

(1) Cash Sale of goods;

(2) Remittances by customers in settlement of their accounts;

(3) Collections made through the Travelling Agents;

(4) Miscellaneous sources, such as dividend, rent, etc.

The system of internal check on receipt from the different sources would vary from each other. They should be as follows: -

2.7.1 *Cash Sales*

There should be carefully planned system of control over cash sales in retail business and large cash stores failing which defalcations will be rampant. Such concerns must equip themselves with cash Registers, with secret total attachments for additions and devices for tabulating the sale of each salesman and each department.

In large stores extensive cash sales take place daily and large number of shop assistance are employed to make sales, a system that has been found to work most satisfactorily is as follows:

(1) Each sales assistant is identified by an alphabet or a number, and is supplied with a Sales Memo Book containing three sets of 50 to 100 sheets numbered consecutively. Each book would bear the alphabet or number of assistants using it and would be accompanied by a carbon sheet. The issue of the books for use should be strictly controlled to prevent frauds.

(2) Sales Memo Book used by different departments should be printed on different coloured papers, so as to facilitate analysis of the sales of each department separately.

(3) As such sale takes place, the assistant enters up the details in the Sales Memo Book supplied to him and prepares three copies of the cash memo with the help of the carbon sheets. The book is then presented to some senior assistant who after checking the correctness of the entries in the memo, initials the same as proof of checking it.

(4) The assistant retains one copy of the memo in the book for his reference and hands over two copies to the customer. The assistant should neither receive cash from the customer nor deliver the goods to him.

(5) The cashier is usually seated in the central position of all the departments so that customers from different departments will pass through him and he can keep a close watch on them to prevent any customer from going out without making payment.

NOTES

(6) The customer goes to the cashier, hands over the two copies of the cas memo given to him by the sales assistant and tenders the amount stated therei to the cashier.

(7) The cashier checks up the correctness of the entries in the two copies of th cash memo, retains one copy and keeps the same in a file for his reference He then writes 'Cash Paid' on the other copy with the help of a rubber stam and hands it over to the customer.

(8) In the meantime the goods must have been sent to the gate-keeper. Custome will produce the copy of the Memo bearing the mark 'Cash Paid' to the keepe and demand the goods. On verification, the gate-keeper will hand over good to the customer. But before doing so he will make necessary entries in good outward register maintained by him. The customer then leaves the shop.

(9) At the end of each day the sales assistant, the cashier, and the gate-keepe will independently prepare Sales Summary Sheets for each of the department from their own records. All these three sheets will now be compared with th other by an assistant of the accounts section and after being tallied, presente to Sales Manager for signature. The Manager will make few test checks befor satisfying himself about the correctness of the sheets and putting his signatur thereto.

(10) The total amount of cash sales is then entered by the General Cash Book.

(11) The cashier is not allowed to make any payment out of the receipt for cas sales. The whole amount should in fact be deposited into the bank on ever day.

(12) The whole system is most rigidly enforced and all discrepancies ar immediately enquired into and thus located without much delay.

While adopting the system, necessary modifications may be made to bui the requirements of the particular business.

2.7.2 *Receipts from Customers*

Customers make payments in settlements of their accounts of the gooc previously purchased by them on credit. Ordinarily they make remittances in cheque They should however, be requested to make payments by cheque drawn in favou into the form and crossed. They should specifically be requested not to draw th cheques in the name of any official of the concern. Notice should also be given them that no receipt would be made unless given in the firm's printed form.

All letters received daily should be opened in the presence of some responsib officer other than the cashier. All cheques and postal orders enclosed there in shou immediately be crossed in the name of the firm and marked 'Not Negotiate, A Payee", if not already crossed by the customer. A list known as Inward Mail Li should be made of all such remittances in triplicate. The remittances along with copy of the list should be handed over to the cashier for entry in the Cash Book. Or copy should be retained for future reference and one copy sent to the Accoun section for posting to the ledger. At frequent intervals, somebody should, compa the list with the entries in the Cash Book. The cashier should send the cheques the next day for collection and deposit the cash in the Bank A/c.

Special printed Receipt books with counterfoils should be used to acknowledge all amounts received as described earlier. No receipt should be given on invoices or statements or plain papers. Each remittance should be acknowledged separately. The receipts for two accounts paid together should be acknowledged in separate forms. If possible, the receipts should be prepared and dispatched by some clerk other than the Cashier or the Ledger clerk or the person receiving the remittances.

After a receipt is made out and before it is torn off from the receipt book, it must be presented to the person authorized to sign it. If it is his duty to compare the contents with the counterfoil before signing the same he should also see that any alteration of the amount or the name of the counterfoil before the receipt is dispatched to the remitter.

The receipt numbers should be given against their respective entries in the cash book in a special column provided for the purpose.

Wherever the size of the business makes it possible the actual handling of cash and securities and the signing of cheques should be done by a different person from the one who writes up the Cash Book. The cashier should not be allowed to make entries in any of the Ledgers or any book of original entry other than the Cash Book.

2.7.3 *Collection by Travelling Agent*

Sometimes traveling agents are allowed to make collections from customers. This system is beset with dangers if proper precautions are not taken. The traveling sales man must not be allowed to meet any expenses or make any payments out of the collections made by him from the customers. At regular intervals they should either deposit all collections in the bank to the credit of the from and rent the amount to the firm along with a statement showing details of collections made by them. The firm should pay them some money to meet their expenses and towards their salary, commission, etc., a separate account of which should be rendered by them to the firm. The traveling agents should be supplied with Temporary Receipt Book for use. Whenever they make any collection, a receipt in triplicate should be made out, one copy will be retained in the book by the traveling agent one copy will be handed over to the customer concerned and the third copy should be sent to the firm for issue of Confirmatory Receipts. On receipt of the copy sent by the traveling agents, the firm will issue a Confirmatory Receipt. As a precautionary measures, there should be a clear modification on the Temporary Receipt that Confirmatory Receipt must follow from the head office within a stated period, of say 10 days, and if not so received, the fact should be intimated direct to the head office by the customer without fail. The statements received from the book at periodical intervals should be compared with the statements of collections received from the traveling agent. In respect of accounts, in respect of which collection is overdue, the head office ;should send reminders direct to the customers concerned. As a final check, periodical statement of account to be issued to each debtor requesting him to intimate the head office the balance owed as indicated in the statement is not correct.

The statement of collection given by the travelling agents should be prepare with the periodical statements received actually deposited by the travelling agent

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2.8 VOUCHING THE DEBIT SIDE OF CASH BOOK

2.8.1 Cash Sales

This is the largest and most vulnerable source of receipt. If an effect system internal check is not in operation, no auditor can guarantee that all money record from cash sales have been actually accounted. Misappropriations can easily ta place courting few sales from the record. Therefore where the auditor finds that system of internal is in existence or that the system in operation is not sound a effective, we should discuss responsibilities as to the correctness of the amou entered in the cash book by mal mentioning the absence of effectiveness of a syste of internal check in his report.

Where a sound system of internal check is in use and auditor is satiated ab the effectiveness and reliability of the system he can safely apply some testi Some of the items, particularly bigger ones, should be picked up from the Sa summon and compared with their respective cash memos. The correctness of t sheet reports, calculation of the price and the total in the cash memo should checked. Some times the Goods Outward Register maintained by the gate-kee should also be compared with the Sales Summary Sheet to ensure that no go left without accounted for. If in the course of these tests, no irregularities have be found or not created, the auditor may safely presume that all items of sales ha been correctly recorded. But the auditor must compare the daily sales Summ Sheet from the sales man, the cashier and the gate-keeper and satisfied hims that they tally with each other. Similarly, the Sales Summary must also be chec by the auditor to ensure that the total amount of sales as recorded in the Cash B has been correctly arrived at. No test checking could be applied to the cases.

Where the cash memo system is not in operation but all cash sales are recor in Rough Cash Book, the auditor should check the daily casting of this blood vouch the entries in the Cash Book with the totals. However, to make himself f from any liabilities, he should mention this fact in the Report.

In some firms cash registers are used. They are however, no guarantee aga omission of some sales. In such cases, the auditor should examine the cash regi and vouch the entries in the Cash Book with this register. The author must dis his responsibilities about omissions of sales in some cases.

As a further check the daily sales of the year under audit should be compa with the daily sales of the previous year and any large fall should be enquired i

2.8.2 Receipt from Debtors

Voucher of the receipts from debtors on open accounts, i.e. those arising f credit sales is of equal importance. This job is not as simple as it appears to b some firms printed counterfoil receipts are not issued to the customers agains payments made by them. The auditor cannot possibly verify the receipts in such cases. Even where counterfoil receipts are used there are many difficulties. The actual amount may be shown in the receipt issued to the customer, a smaller account entered in the counterfoil and the Cash Book and the differences misappropriated. If issue of Counterfoil Receipt Book for use is not strictly controlled unused books may be utilized to misappropriate money. Besides the question of allowance, bad debts is also there, they are not properly regulated. An amount received from a customer might be misappropriated and shown in the books as allowance given to the customer or later on may be written off as bad debts. However, where the cashier has no access to any ledger account or Subsidiary Book, particularly the journal proper, this kind of fraud would be difficult.

The auditor, therefore enquire into the system of internal check in force on receipts from debtors the system of depositing such receipts into the bank, the system of control over the use of Receipt books and above all, whether the cashier maintains other ledger accounts or Subsidiary books. If he finds that system is not a reliable one he must state the same in his report The counter foils of the Receipt Books are the documentary evidence available to the auditor for vouching the receipts from debtors. He should vouch counter foil receipts with entries in the cash book thoroughly. He should see that the dates on the counterfoils correspond with those in the cash book. He should check the debtor's ledger intelligently to find out any outstanding debt. He must seek explanation for the same as mere agreement of counterfoils with cash book is no conclusive proof of its accuracy.

When travels are allowed to collect money from customers, the regulations in force should be certain and it should be seen that they are sound and rigidly adhered to. If the travelers issue counterfoil receipts, the counterfoils should be tested by the auditor. The travelers statements, giving particulars of the amounts collected, should also be examined and compared with the actual receipts in Cash Book. If the traveler is depositing the amounts in a bank, the periodical Bank statements should be compared with the travelers statements.

Discount allowed to debtors is usually entered in a special column on the debit side of the cash Book against the receipt to which it relates. The auditor should ascertain the terms (i.e. period of credit and rate discount) on which discount is allowed, and test a certain number the entries to ascertain whether the discount allowed is in order. This is important, as defalcations in respect of receipts may be concealed by means of fictitious entries of discount. Where the rate of discount allowed to a customer is higher than the usual rate, or where discount has been allowed even if payments has been made after the expiry of the usual term of credit, the auditor should demand production of authority for such special treatment without which he should refuse to pass the item.

He must also enquire into the system of writing off a debt as irrevocable and bad one. Generally, a debt is written off as bad by the Board of Directors, in the case of a company, and by the partners in the case of firm. The auditor must examine the resolutions treating a debt as bad one. He should also examine all the

correspondence and steps taken to recover the debt before writing off the sar
bad in order to satisfy himself that all possible steps had been taken before tre
the debt as irrevocable.

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Over and above these checks, the auditor should, with the help of his owr unaided by the employees of the firm, prepare extract copies of personal acc of the debtors from the Debtors Ledger, and with the permission of the clients these to the debtors with a request to confirm the entries therein or the objec erroneous entries are there, and to send them direct to him. From the objectio any, he can detect defalcations.

2.8.3 *Hire-purchase Sales*

Where money is received of the installment relating to goods sold on purchase system the amount includes partly principal and partly interest. The w amount, therefore, should not be credited to sales account. The auditor sh examine the agreement and find out the amount creditable to interest account should be very sure that the amount is properly divided between principal and inte and that the amount of principal is credited to sales and the amount of intere interest account.

2.8.4 *Consignment and Agency Sales*

The amount received from consignees and agents on account of sales m by them should be verified with the Account Sales received from them. The auc should see that the Account Sales are certified by some responsible officia correct.

2.8.5 *Interest and Dividends Received*

Interest may be received on deposits with banks, on investments in Governm securities or Debentures and on loans.

In case of interest on deposits, this should be vouched with amount credi by the bank in Pass Book belonging to the client.

The rate of interest on Securities and Debentures and date of payment c be ascertained from the securities. The auditor should inspect the securities a calculate the amount receivable as interests. Where a large number of investme is held, an Investment Ledger showing the amount of investment on each Secur the rate of interest and the date of payment will usually be found. Such Securiti usually carry interest at a fixed rate on its nominal value and therefore, present difficulty for calculation. It should be seen that this amount has been received a accounted for. The amount debited to the Cash Book can be verified from t counterfoil of the Interest coupon or the covering letter sent with the chequ representing the amount of interest. If interest is collected through the banker t nk Pass Book will reveal the amount.

For interest on loans the auditor should examine the Loan Agreement and fi t the principal amount and date of the loan and the rate of interest. The amou eceivable can now be calculated by him. The amount entered in the debit side he cash Book should be vouched with the counterfoil of the receipt given to th borrower. If interest is outstanding this should be ascertained by writing a letter to the borrower with permission of the client.

Dividend is received on investment. In case of registered securities, the amount of dividend received should be checked from the counterfoils of Dividend Warrants, and in case of Bearer Securities from the counterfoils of Dividend Coupons. When Dividend is collected through the banker, the amount can be vouched with the Bank Pass book. The auditor should be particular to see that interest on ex-dividend sales and cum-dividend purchases have been duly received and accounted for. If care is not taken, this amount can be easily misappropriated. For the Bankers Sales Note the auditor can know whether it is an ex-dividend sale and from the Bought Note whether it is a cum-dividend purchases. In both the cases, the next dividend payable after the sale or after the purchase of the securities is receivable by the client. The auditor should therefore be very particular about receipt of the next dividend on ex-dividend sales and cum-dividend purchases.

2.8.6 *Rents Received*

In order to vouch the income derived from the source, the auditor should inspect the leases and agreement and note there from the name of the tenant, the rent payable, date of payment, provision for repairs and allowances etc. Where the client owns a large number of houses or estates, usually a rent roll is prepared showing in detail the name of the property, the name of the tenant, date of occupation and rent payable. The auditor should also examine this rent roll and see that the total amount of rent that should have been received has been duly accounted for. The enterprise in the Cash Book relating to the receipt of rent should be verified with the counterfoil of receipts given to the tenants. Any deductions made by the tenant should also be vouched.

The auditor should pay particular attention towards rent outstanding. It is possible that rent might have been received but misappropriated and the amount may be shown as outstanding. In such a case, if the outstanding amount is a heavy one or is a long one, with the permission of the client, the auditor should write to the tenants concerned requesting them to confirm the outstanding and send the intimation direct to him. Similar precautions must be taken in respect of properties which are shown as unlet or vacant for sometimes. In fact such property might not have remained vacant and the rent received might bave been misappropriated. From the correspondence with the previous tenant he can ascertain the date on which the house was vacated by him and from the agreement with the new tenant he can ascertain the period of vacancy, if any. He should also get a list of such unlet or vacant property duly signed by a responsible official.

2.8.7 *Bills Receivable*

The auditor should examine the Bills Receivable Books to ascertain the due of arrear bills. The proceeds of those discounted will be received prior to maturity, and should be vouched by reference to the "How disposed off" column of the Bills Receivable Book or Bill discounted Book, the Bank Pass Book and the rate of discount charged. Those bills till maturity should be received in full on the due dates and should be verified from the Bills Book. If not so received they will either have been retired and the new bill given, which can be seen from the letter of request c the drawee of renewal, or dishonoured, which can be ascertained from the intimatio received from the banker notice of dishonour given to the drawee. In any case, a matured bills which have not been accounted for in the Cash Book must be trace by the auditor to prevent defalcation of moneys received. All unpaid bills remainin in hand should be verified with the Bills Book. Contingent Liability at the date of th Balance Sheet should be shown at the foot of the Balance Sheet.

2.8.8 *Commission*

Commission is received by the client for acting as agent or consignee of som other businessmen. In such a case, the auditor should inspect the consignment c the Agency Agreement and ascertain the rate of commission payable. From th Account Sales rendered by the client to the Principal the total amount of sale o which commission is payable can be ascertained. The auditor is now in a positio to determine the total amount of commission that should have been received by th client. The entry in the debit side of the Cash Book will be vouched with the amour thus, arrived at the counterfoil of the receipt issued by the client in acknowledgmer of the receipt of commission.

2.8.9 *Sale of Investments*

The amount received on account of the sale of investments should be vouche with the Broker's Sold Notes which will indicate the net amount receivable. If the have been sold through the bank, the bank advice will provide the evidence fc vouching. Where investments are sold cum-dividend, it should be seen that th amount received is correctly appropriated between the amount creditable t Investment Account and the amount creditable to interest or Dividend Account. they are sold ex-dividend, the auditor should particularly see that the next dividen has been received and duly accounted for; otherwise it may be misappropriatec Where any investment has been sold in respect of any earmarked funds, such a Sinking Fund or depreciation fund etc. The whole amount received should be credite to the particular fund investment account.

2.8.10 *Sale of Fixed Assets*

Old Fixed Assets such as Land and Building, Plant and Machinery, Fixtur and Furniture, etc. may be sold either by contract or by auction. The proceeds fror such sale should be vouched with the auctioneer's account, if sold by auction c should be proved by the production of sale contracts, correspondence, or othe documents relating thereto. It should be seen by the auditor that the amount is credite to the appropriate asset account and not to the Sales Account.

All other receipts recorded on the debit side of the cash book should b vouched with the appropriate documentary evidence.

Credit Side or Payments Side of the Cash Book

There must be a voucher or documentary evidence obtained for every paymen In examining the vouchers for cash payments, the following points should b particularly observed by the auditor :

1) That the client must be mentioned as the payer. Any voucher in the name of any employee of the undertaking should not ordinarily be accepted as evidence of payment.
2) That the payee's name is properly stated in the Cash Book.
3) That the date, month and the year in the receipt agree with the corresponding entry in the Cash Book.
4) That the amount is properly entered in the Cash Book.
5) That the item of payment is duly authorized and is properly chartable against the business and not by any of its employees.
6) That the amount is allocated to the correct account i.e. revenue or capital.
7) That the narration in the cash book sufficiently explains the nature of each entry.
8) That the signature of the payee appears to be genuine.
9) That every voucher of the value of Rs.20/- or more bears a revenue stamp of Rs.0.20p.

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The auditor must not pass any transaction unless it is supported by a proper voucher. After vouching he should cancel the voucher to prevent the same being produced in support of any transaction. Some special payments cannot be vouched in the usual way; (for example, insurance premium on a new policy) but satisfactory evidence that the payment was actually made and value received should always be obtained. If some vouchers are missing he should ask for production of duplicates which he must not pass for the transactions.

Internal Check

1) All payments other than those for wages and petty cash should invariably be made (where possible) by cheque payable to order and crossed.
2) A proper acknowledgement should be obtained in support of every payment and the vouchers should be consecutively numbered. All such vouchers should be kept in a separate file in a serial order so as to facilitate verification.
3) The number of each voucher must appear against the respective entry or payment in the Cash Book in special column provided for the purpose.
4) No cheque should be drawn for payment to a creditor for goods purchased, unless the periodical statement received from him is verified with the Ledger Account and initialed as correct by the official who did the checking. Each such statement there be passed for payment by one of the partners, the managing director or someone in authority.
5) The Cash Book should be verified with the Bank Pass Book and a Reconciliation Statement prepared and entered in a book provided for the purpose at least once a month. This can preferably be done by someone other than the cashier. And discrepancy should immediately be investigated into.

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6) The office Cash Balance should be counted at regular intervals and with the Cash Book by some responsible official.

7) All cheques should be signed by one of the partners or some authorized The person signing the cheque should also initial their corresp counterfoils, and alterations, made in the cheque. The cheques sh signed by the official concerned in his own hand and not by any other r such as giving rubber stamps.

8) In large undertaking it is often highly desirable to have cheques counte i.e. signed by two different officials. But no official should be given sign advance before the cheque is written up nor should signatures be gi perfunctory manner, i.e. by the use of rubber. This will defeat the pur counter signature.

9) All cheque books should be kept under lock and key under the char responsible official and issue of cheque book for use should be controlled. A new cheque book will be issued only when the old one ha completely exhausted.

2.9 VOUCHING

The detection of frauds depends largely upon an intelligent and careful vo of the payment side of the cash. In the absence of a properly working sys internal check as described above fraud cannot altogether be avoided. The should therefore enquire into the system of internal check on cash payment finds any loose ends he should not only disown his responsibility, but also suggest to the client to make the system an effective one.

Some of the important items which usually appear on the credit side Cash Book and the duties of the auditor relating thereto are given below.

1. Wages

This is one of the most important items of payment in a manufacturing co Instances of fraud in the payment of wages are among the most frequent o that come under the notice of the auditor. Ghost names and more than the n actually employed may be entered into the wages being taken by dishonest w by forgoing signatures or putting else 'thumb marks' and sharing the wage w paying-in-clerk. Similarly, signatures of absence workers may be forged an wage misappropriated. These things are extremely easy where an effective s of internal check over recruitment of temporary workers, recording of preparation of wage sheet and payment of wages is non-existent. Circums evidence is thus the best available method for the auditor, and this will cons good system of control which renders fraud impossible. The system should follows :-

Temporary Recruitments

It is the unregulated recruitment of day-to-day temporary workers that c all problems. Recruitment of temporary workers, by different departments s therefore, be controlled and a full record of all such recruitments be kept s adding the number of such workers to the number of permanent workers, the total number such workers of each day to whom wages are payable can be arrived at. All temporary recruitment should be made by the work manager carefully examining the requisitions made by the Foreman. Each recruitment should be justified in writing.

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Time Records

Wages are paid on two methods : (1) Time Rate and (2) Piece Rate, most of the cases the time rate system is used. In such a case, it is important to keep a correct record of the time spent by each worker at work for which he is entitled to wages. The importance of a correct time record can be explained by an example. If, in a factory there are 1000 workers and they come one minute late and go one minute earlier every day and in a month, the factory would lose 6000 man-hours and if the wage rate per hour is Rs.2 the total loss in a month would come to a staggering figure of Rs.12,000/-. This emphasizes for accurate recording of the time of arrival and time of departure of the worker from which the exact time spent by him at work, and therefore the amount of wages to which he is entitled can easily be worked out. Time records are usually kept in three methods. They are :-

1) Gate register System :
2) Metal Disc System
3) Time-recording clock system :

In the last two systems the workers is supplied with a job card showing is name, age, address and other particulars, the workshop to which he belongs and the number and wage rate. Job cards are used to have a double time record and to prevent the worker from wasting his time by loitering or chit chatting after crossing the factory gate but before reaching his workshop.

Gate Register system of time keeping is generally in use in small actives where the number of workers does not exceed, say 2000. Names and job numbers etc., of the workers are printed in bound registers and the register is supplied to the gate keeper. Separate pages are used for each week. When the worker goes to the factory he gets the time of his arrival entered in the gate register against his name by the gate-keeper. The time of departure is closing time of the shift being the same for all workers presents no difficulty to the gate-keeper to record. Thus, absentee and late arrivals are noted for deduction in wages.

In a factory of the medium size employing 200 to 350 workers the gate register system is unsuitable. The gate keeper ;will take lot of time to record the time of arrival of so many workers before allowing them to enter in. In such a case, the metal disc system is opted. Under this system each worker is allotted a number and these numbers are inscribed on metal discs. These discs are hanged into the wall in the time keeping room at the factory gate. The time keeper sits there with the time register and a box kept near him. The time register contains the name and address, rate of wage, workshop to which he belongs and job number, etc. in printed from. When the worker comes for, he enters into the time-room, picks-up his metal discs and insert the same into the box meant for the purpose and then goes to the workshop. At the workshop he entire the date and time of the arrival in his job card

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and produces the same to the Foreman. After verification of the entries the Fore puts his signature on the job card and allows the over to start his day's work. I time room, at frequent intervals of one or two minutes, the internal discs are colle from the box by the time keeper and the box is emptied with help of the metal of each lot collected from the box, the time keeper enters the time arrival o workers bearing those numbers in the time-registers. Thus, the exact time of worker is correctly recorded and late arrivals and absentees noted. The time ke has to particularly see that no worker is inserting more than one disc into the and no worker rafter entering in the factory comes back to the time-room to pu disc of an absentee work into the box.

In large business, howe ver neither the Gate Keeper Register nor Metal – System is found appropriate where large number of workers are in employn and a mechanical device in the form of Time-recording Clock is used to keep of arrival of workers. The clock is installed at the factory gate in a time-room. A keeper sits near the clock to see that no worker inserts more than one Job card the clock so as to prevent worker from getting the time recorded of an abser worker. When the worker comes for work, he goes into the time room, inserts Job Card into the time-clock. The date and time are then automatically recorde the job card and the card comes out of the clock. The worker carries the card to Foreman of the workers. If the foreman does not find any significant differe between the time recorded on card and the actual time of arrival of the worker at workshop, giving due allowance for time to cover the distance between the fact gate and the workshop, he puts his signature on the card and allows the worke start work. In case of any significant difference in time indicating wastage of so time on the way to the workshop by the worker, wage is deducted accordingly.

After the start of work none is allowed to leave his factory without permissi For temporary absence, the foreman issues a Gate pass showing the name, number, the workshop of the worker and the time of departure. Only on product of this pass at the Gate the worker is allowed to go out or come in during worki hours. On return, the worker surrenders the Gate Pass to the Foreman who reco the time of arrival and keeps the pass for preparation of the Wage Sheet.

In the workshop if the worker indulges in acts of indiscipline or breaks tools wastes materials or does any other punishable offence and is punished the same noted by the Foreman on his Job Card for deduction of his wages.

At the end of the week the Gate Register or the Time-Register, the Job Car and the used Gate passes are collected for preparation of the wage sheet a fresh registers and cards are issued for use.

Wages Sheet

With the help of the aforesaid documents the wages sheet is prepared. F each workshop a separate wage sheet is prepared. It is generally kept in a bour register. The sheet contains a number of columns for entering the name, job numb of the worker, the rate of wages per hour or per piece, the number of hours of wo put in by the worker during the week as found out from the time record and Jo Card, gross wages payable, deductions to be made for fines, advances, cost rations supplied etc., net wages payable and space for signature of the worker. More than one clerk should be engaged to fill in the different columns of the wages sheet and the columns should be checked by another one or two clerks. All the clerks engaged in the preparation and checking of the Wages Sheet should put their signatures stating the role played by each of them so that in future if any error is detected responsibility can easily be fixed. The wages sheet is then placed before the works manager for signature. He makes a few test checks and if finds them correct, signs the sheet. Orders for payment of wages are then issued by the General Manager.

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Payment

The Cashier draws a single cheque for the total amount of wages payable. Wages are paid by a clerk who was neither employed in the preparation of the wages sheet nor the cashier. At the time of payment the departmental Foreman, the Cashier or his representative remains present. At the time of payment the signature of the worker or his 'thumb mark' is taken on the Wages Sheet in space provided for the purpose. Wages of an absentee worker is not paid to anybody else unless a clear written authority from the worker concerned is produced. The wages sheet is then signed by the paying clerk, the foreman and the cashier. A list of absentee workers and the amount of wages due to them is prepared. The amount of cash with the paying clerk must tally with the amount shown by the list. The list and the unpaid amount are then handed over to the cashier.

Duties of the Auditor

Where the auditor finds that there is no internal check or recruitment of causal workers, recording of time, preparation of wages sheet and payment of wages, he should disown all responsibilities relating to wages by stating this fact in his report. But where the system of internal check is in conformity with the one described above, he should apply some test checks. Wages Sheets of a few weeks may be taken at random, compared with the original records and checked exhaustively; few items from other wages sheets may be tested, and if no irregularity is detected, he may take all the sheets to have been correctly prepared. In any case, the total of the wages sheets must be checked by him. The auditor should do well to pay a surprise visit at the time of payment of wages to make sure that the internal check is being carried effectively. The entries on the credit side of the Cash Book should be vouched with the wages sheet.

The object of the auditor in verifying the item of wages is to satisfy himself that the payments as recorded were actually made, that they were properly authorized and were accurately ascertained.

2. *Salaries and Commission*

Usually a Salaries Book is kept showing particulars of monthly salaries paid to the employees. This should be examined by the auditor and the monthly totals checked. He should see that the total of the Salaries Book for a particular month agrees with the cheque drawn for the month of salaries or the entry in the Cash Column of the Cash Book and that for every payment made the signature of the

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employee concerned has been obtained. The salaries of secretaries, man
important officials would be fixed by the Directors, and the Board's Minu
should be consulted for the purpose. Any change in the salary list owing
appointment, or increment in salary allowed to certain employees or allowan
should be verified by the auditor by demanding production of proper auth
should see that necessary deductions for Provident Fund, Income-tax etc.
advances taken or cost of rations supplied, house rent etc., have been ma
Employees' State Insurance records should be tested with the entries in the
Books. Salaries may also be verified with the Annual Returns submitte
Income-tax Department regarding the payment of Salaries.

For payment of commission to agents, agreements made with ther
be inspected to ascertain the actual basis on which the commission
calculated and the arrangements, if any, regarding expenses. Usually the pe
of commission would be calculated on the Net Sales, i.e. after deduction of
allowance and Bad debts, unless there is any stipulation to the contrary
cases, it is highly desirable that a proper record be maintained of the sales
through each traveling salesman. For payments made to travelers, receipt
by them should be inspected. The commission records should be exami
some of the calculation tested.

3. *Payments for Goods Purchased*

All cash purchases should be vouched with the Cash Memos recei
the suppliers. As cash purchases are rarely made the auditor must satisf
that such purchases have been duly authorized. In the case of payments to
for goods purchased earlier on credit, the receipts from the creditors ackno
the receipts of the amounts should be sufficient for the purpose of vouch
auditor should enquire whether periodical statements received from the
are properly checked with the Ledger Accounts before passed for payment
responsible official. As an added measure of check, he should, with the pe
of the client, send copies of personal accounts of the creditors to them with
to confirm the entries or object to them in case of errors, so that he can m
about payments made. He should also see that cash discount, if any, fo
payments has been availed of as net amounts have been paid.

4. *Travelling expenses*

Travelling expenses cannot, as a rule, be substantiated by vouche
usually admitted on the certificate of a responsible official. Where a limit
any particular case, the auditor should not pass any excess payment to the e
concerned but should ask for recovery by examining the nature of the e
The auditor must satisfy himself the expenses were necessarily incurre
business and are properly chargeable to the business, failing which he s
pass them. The agreements with travelers should be inspected to ascer
the stipulations are as to traveling expenses. All outstanding expenses s
provided for and the receipts of acknowledgement should be vouched.

In case of Directors, it should be noted that they are not entitled to
expenses incurred by them for attending Board meetings unless the co

articles specifically allow these, or the company in general meeting authorizes such payment.

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5. Miscellaneous Expenses

Other payments for establishing expenses, such as Rent, Taxes, Insurance Premium, Advertising, Lighting, etc. should be supported by well recognized vouchers. While vouching these expenses, the auditor should carefully note the period covered to see if they would require adjustment or apportionment for the purpose of being included in the final accounts as outstanding liabilities or payments in advance.

6. Railway Freight and Custom Duty

These accounts require careful examination as the sums involved sometimes are very large and special opportunities exist for fraud in connection therewith. The payments for railway freight, carriage and customs duty must be vouched with the accounts rendered by the authorities concerned. It should be seen that rebates allowed by transport authorities have been availed and properly brought into account, i.e. the actual cash payment corresponds with the net amount payable.

7. Petty Cash Payments

These are small payments of less than Rs.20/- each but are very large in number and afford numerous opportunities for manipulation. The auditor should not therefore, regard them as unimportant though important frauds are hardly likely to occur in petty cash. Vouchers cannot be obtained for a large number of petty cash payments and in such cases a list of such payments be made and certified by a responsible official. The transactions are so numerous that no auditor can undertake a detailed checking of petty cash payments and it will not be possible for auditor to satisfy himself by the usual method of vouching that all payments are in order.

How far the auditor should vouch details of the petty expenditure is a question to be decided with due regard to the system in use. He must use his judgment in each particular case. If the Petty cash Book is maintained under the Imprest System and is periodically i.e. monthly checked by the Cashier, it should go far towards satisfying the auditor that payments are justifiable. The cheques issued for Petty Cash by the Cashier would be vouched with the Petty Cash Book. He should check at least all the vouchers for a period selected by way of test or see vouchers for all payments, say Rs.5/- and upwards. Petty acts of pilferage almost constantly occur and it is therefore, difficult to lay down any hard and fast rule for vouching in this case. The auditor should see that no large amounts are paid through the Petty Cash and that the Petty cashier is not allowed to receive any amounts however small except by way of Imprest cheques. He should check casts and cross casts and see that expenditure is properly analysed and posted to their correct accounts. By an actual count he must se that the balance unspent is in the hands of Petty cashier. Beyond this he should not attempt to go.

Along with the Petty Cash Book, the auditor also examines the Postage Book. He should apply some test checks to satisfy himself about the correctness of the postage account. It should be seen that the Postage book has been regularly checked and the balance of stamps in hand be counted. Some entries in the Postage Book should be verified with the Letters Despatch Register.

NOTES

8. Land, Buildings Purchased

For vouching this item the auditor should examine the agreement for s conveyance. The Title Deeds conferring the legal title of the property on th the receipt showing the money paid and the registration deed legal charge i i.e. registration charges, stamp duty, Lawyer's fees, etc. incurred in cor with the acquisition of the property will be wanted with the solicitor's bil Brokerage paid should be checked with the broker's receipt. These exper to be treated as part of the cost of property and debited to the property acc not to any nominal account. The auditor should also refer to the minute bo Board to see that the purchase has been sanctioned by the directors. If the has been purchased in an auction, the auctioneer's accounts would be vo

If the building is constructed under contract, the architect complain c the builder's or contractors receipt acknowledging the payment and the with the builder will be seen. The fees paid to the architect should be ca and debited to the building account.

9. Purchase of Plant and Machinery ; and Furniture and Fixtures

If they have been bought in an auction, the auctioneer's accounts s verified. If they are purchased from a supplier the receipt form the vend seen. If these are acquired under a hire-purchase agreement, the auditor to see the agreement in addition to the voucher; he should also see that th paid as installment is properly allocated between cost of the asset and Carriage paid to bring the asset, erection charges of the machinery to p working condition and other expenses incurred in connection with the asse treated as capital expenditure and debited to the asset account.

10. Patents and Copyrights

The monopoly right to manufacture and sell chemical goods or m known as patent-right which is purchased from the inventor. Similarly the r right to publish and sell a book is known as copyright and this is purchase original author. Such payments should be verified with the contract for sa voucher acknowledging the receipt of the purchase consideration. Legal e such as registration charges shall be charged to the Patent or Copyright and vouched with the agent's accounts. Renewal expenses to get the renewed at the expiry will be treated as revenue expenditure.

11. Payments under Hire-purchase or Deferred

Where the payments are made under any Hire-purchase or Installments Agreement, the auditor should inspect the Agreement anc proper apportionment is made between principal and interests on recording of each installment. He should also see that under no circumstance the ass is debited with anything beyond its present cash price. The payment a verified with periodical statements received from the hire-trader. T agreement should be examined.

12. *Investments*

NOTES

Payments for the purchases of shares, securities, etc. should be vouched with the Broker's Bought note, other's receipt and the securities themselves. Where the investments are purchased and the auditor should see that the dividend paid immediately after the purchase is received and duly accounted for. The price paid for the purchase should be apportioned between the cost of the securities and the accrued interest and the total amount should not be deposited to the investment account. He should see that investments have been purchased through the resolution of the Board, the minute book of directors should be examined.

In case of re-purchases of shares from a newly formed company, the letter of allotment of the shares in the name of the client and the banker's receipt, for the installments (calls) paid should be examined.

In short, correct entry in the Cash Book must be supported by documentary evidences known as voucher which may take the shape of receipts, invoices, cash memos, counterfoils, resolutions, promotions in the Articles and Memorandum, Prospectus and even correspondence. The auditor examine the genuineness and correctness of these forming vouchers and the correctness of the entries in the Cash Book. If the audit takes place sometimes later than the closure of the books as it does, the transactions recorded in the Cash Book after the closure till the date of recording also be examined by the auditor to arrive at the correct balance. The actual amount cash in hand should agree with the balances thus arrived at.

The payments into the Bank Account and the withdrawals or payment from such account should also be checked with relevant documentary evidences. The book balance as shown by the Bank pass Book should be reconciled by preparing a Reconciliation statement . The cheque both paid in and drawn that are not entered in the Pass Book at the head of accounts and which appear in the reconciliation statement should be traced through into Pass Book for the succeeding period.

In order that such outstanding are bonafide transactions, if the audit takes place sometimes after close of the financial period, and these are outstanding that are still not through the Cash Book, it should be seen that the dates and names agree, because it provides scope for fraud. Frauds have been covered up in the past by producing to the auditor a dummy pass Book, and therefore, in order to guard against this, the auditor should obtain direct from bankers a certificate of the balances to the books of the bank, as at the close of the financial year of the concern whose accounts are being audited, and it must be seen that these balance agree with the balances shown by the Pass Books produced. When making application to client's bankers, the auditor should ask for a certificate as to the all details of the clients accounts with the bank and particulars of any bills, securities, etc. held by the bank on behalf of the client. There have been cases in which there have been accounts in to the bank of which the auditor had no knowledge.

SELF TEST – 5

1. What is the objective of vouching the Cash Book ? Discuss in brief the method of vouching the items of cash receipts under different heads.

2. Discuss the process of vouching the payment side of cash book under differ heads
3. What is the importance of the audit of cash transactions ?
4. Discuss the role of the auditor in vouching cash transactions.

NOTES

5. write short notes :
   i. Vouching of Cash Sales.
   ii. Vouching of Wage Payments.
   iii. Vouching of Petty Cash Payments.
   iv. Vouching of interest and dividend received.

2.10 VOUCHING OF TRADING TRANSACTIONS

In our day to day business life, we find that purchases and sales are t important items of any business concern Vouching of Cash Purchases and Ca Sales has already been discussed in the previous chapter. In vouching the tradi transactions, the auditor must exercise great care in regard to purchases and cre sales. Here the auditor is concerned with the checking of the purchase Book a the Sales Book. The main object of vouching these two important books is to preve misappropriation of goods. Below is given the procedure of vouching of Pass Boo

Purchases Book

Purchases book is also known as Bought Day Book or Bought Journal Invoice Book wherein only credit transactions of goods in which the trader deals a recorded. Auditor should see the records only for those goods which have bee ordered for the business and which have been received and accounted for.

Internal Checking in Purchases

The first duties of auditor should take in Vouching the Purchase Book is investigates into the system – check in force regarding purchases. This is ve important because without an effecting checking and control system in regard purchase, opportunities for fraud are very general, Check system has not been operation or it is defective and not reliable that should exercise considerable ca in examining the Purchase Book. As regards the internal check in force, he shou see that the following points are observed by his client :

a) Their should be proper record of all orders. These orders should be made o in duplicate that copy of the order must be sent to the supplier while the carbo copy is in office.

b) Goods received should be recorded in the Goods Inwards Book maintaine by the storekeeper. The auditor should check the goods with the delivery note sent by suppliers.

c) It should be compared with the order form and the Goods Inwards Book. Th goods in respect of quantities, qualities, weight etc. should be checked.

d) After checking the details the invoices should be sent to Purchasing departmen or Section which placed orders for goods for verification of prices, quality etc

e) The person in charge of the Purchase Department then passes over the invoices to clerk who records all particulars of the invoices in the Purchase Book.

f) All the invoices should be numbered, signed and filed systematically for future references.

NOTES

Vouching of Entries in the Purchase Book and Auditor's duty

For vouching the entries in the Purchases Book the auditor will require the invoices relating to Purchases, the Goods Inward Book and Delivery notes. He should ask his client to arrange all the invoices serially and in the same order as that of entries in the purchases Book. While examining the invoices the auditors should pay special attention to the following points :

1. The invoices are in the name of his client. Sometimes employees of the client purchase goods through the concern in order to take the advantage of trade discount. In such cases auditor should see that the goods are debited to the concerned employee's personal account.
2. The date of the invoice should correspond to the period under audit.
3. Invoice is checked by some responsible officer who is authorized to place orders.
4. Invoice relates to those goods which are dealt with by his client.
5. Trade discount, if any, has been deducted from the amount of the invoice and net amount is shown for which entry has been made.
6. Invoices relating to the purchases of capital goods should not be passed through the Purchases Book. Such invoice should be checked with the entry in the Purchases Book.
7. Name of the creditor in the invoice should be checked with the entry in the Purchases Book.
8. He should compare a few invoices ;with the Goods Inward Book in order to ensure that the goods have actually been received. Such test check would present the inclusion of fictitious invoice or submission of duplicate invoices.

The auditor should pay special attention to the fact that the management has not inflated profits by not showing all the invoices relating to the purchases of goods. To check this, in particular, the auditor should compare the entries in the Purchases Book with the entries in the Goods Inward Book during the last few weeks. He has to ensure that entry has been made both in the Purchases Book as well as the Stock Book. In order to ensure that all invoices have been included, the auditor, with permission from his client, should send for confirmatory statement of accounts from the creditors. If these statements reveal any discrepancy, he should investigate this.

Sometimes auditory may come across invoices marked 'duplicate'. In that case he should satisfy himself that they were obtained in respect of only those invoices which have been actually lost. The invoices which have already been examined should be duly cancelled so that these cannot be shown as a documentary evidence in support of another entry.

The auditor should check totals, sub-totals, carry forwards and a reas
number of calculations in the Purchases Book. He should also check postin
the Purchases Book to the ledger accounts.

NOTES

In short the auditor is to ensure that whatever goods are purchased, th
properly ordered, received, inspected and then duly accounted for in all the r

Purchase Returns

Goods are returned to the suppliers for various reasons like.

a) The goods may not be of the kind ordered or may be of inferior quality
b) They may not have been delivered in time
c) They may have been damaged in transit, or
d) They may otherwise be unsatisfactory or defective

When such returns are very rare, separate books for returns may r
prepared by the concern but when such transactions are many these are ente
a book known as Purchase Returns Book or Returns Outward Book. In any c
Credit Note should be obtained from the supplier if the price has already been
If price has not yet been paid a note should be sent to the cash section to sen
amount to the concerned suppliers.

He should compare the Credit Notes sent by the creditors with the entr
the Purchase Returns Book and the Goods Outward Book. Credit Notes are
received from the sellers when they give an allowance for damages, short w
and errors in calculation etc. The auditor has to examine that such adjustm
have been made in records. Heavy returns may be there at the end of the ye
beginning of the next year, which has to be carefully examined by him with pr
documentary evidence. Postings and Castings of Purchases Return Book sh
be checked with the ledger accounts.

Sales Book

Sales Book is also known as the Day Book, wherein credit sales of go
dealt in by client are recorded. The procedure of vouching of Sales Book is gi
below :

Vouching of the Sales Book is a much more difficult task than that of
Purchases Book because the documentary evidence i.e. duplicate of invoice is
very reliable.

Internal Check Regarding credit Sales

The auditor should enquire into the internal check system regarding the sa
and see that the following points are observed by his client :

a) Whenever an order is received, it should be recorded in the Order receiv
Book, giving details regarding the date of receipt of order, the name of t
customer, particulars about the goods, date of delivery, mode of transport e
b) A copy of the order is sent to the dispatch department.

c) After the goods are packed, another clerk should compare the goods so dispatched with orders received, or a separate list prepared by him, and the same is sent to the Counting House.

d) In the Counting House a responsible official marks the rate at which the goods are to be charged.

e) Invoice (outward) is prepared in duplicate or triplicate copies by means of carbon papers. One copy of the invoice is sent to the invoice clerk for recording it in the Sales Book. One copy is sent to the customer. Another copy is sent to the gate-keeper for record in the Goods Outwards Book.

f) Sometimes orders are received through the traveling salesman. In such case they should be given order books with triplicate copies-one copy is handed over to the Customer, the second copy is sent to the head office for action, and the third copy is retained by the traveling salesman for his own reference and record.

Vouching of Credit Sales and Auditor's Duty

While vouching the Sales Book or Sales Journal containing Credit Sales goods, the auditor should adopt the following procedures :

1. He should study the system of internal check in force in the business. If he is satisfied with the internal check and control system, he may have some test checking. If he is not satisfied with the working of the internal check system, he should disown his responsibility of informing the higher officials.
2. He should see that sales of capital items, i.e. assets should not be included in the Sales Book.
3. He should see that no sale is omitted to be entered in the Sales Book. If this happens, money can easily be misappropriated on receipt of the same later as there is no other record of entry for such sales. Such frauds can be detected by the auditor if he compares the copies of invoices. Orders Received Book, Goods Outward Book, Delivery Note duly signed by the purchaser, receipts issued by transport agencies etc.
4. The auditor should prepare a statement of accounts of customers and send the same to customers to confirm accuracy of balances. Such procedure will reduce fraud to a great extent.
5. He should check the Casts, cross Casts and carry forward of the Sales Book and compare them with ledger accounts.
6. He should examine entries made in the Sales Book for the last few weeks of the year to prevent the likely fictitious entries.
7. He should also check the trade discounts and try to find out, the reasons for an unusually high or low rate of discount allowed to customers.
8. He should see that the cancelled invoices have been checked properly and preserved systematically for future references.

9. He should also see the sales tax, insurance charges for which the custon accounts are to be debited have been duly recorded in the accounts.

Sales Returns

Sometimes goods may be returned by the customers to whom these v sold, for the same reasons indicated earlier (in Purchase Returns) when such ret are rare, separate books for returns inward may not be maintained by the client when such transactions are sizeable, a separate subsidiary book known as S Returns Book or Sales Journal is maintained. If internal check system in this reg is satisfactory the auditor should compare the entries in the gate keeper's b with those of the Stock Register along with correspondences with the custom These are further compared with Credit Notes issued to customers and debit N received from customers.

The auditor has to ascertain that some goods have actually been retur and that the client does not have the fraudulent intention of misappropriation o goods on the account. An unusual time lag between sale and return may result in deterioration of the quality of goods. After examining the condition of the retur goods only, the auditor may allow Credit Note to be issued in favour of custome the client.

The auditor should also check castings and postings of the Sales Retu Book and the ledger accounts.

Goods Sold on Sale or Return System :

Very often goods are sold to customers on sale or return basis or on appro In this system goods are delivered to a customer on condition that if he does approve of the goods, he can return them within a particular period. In such a c goods sold on approval basis cannot be treated as complete sale until the custor approves the goods. In case it is treated as sales and shown in the accounts, it inflate profit. The auditor must see if there is such goods until approval, it wil deducted from sale a debtors.

The auditor should instruct his client to prepare a list or schedule of such goo in the hands of customers, and if such transactions are numerous, he should instr his client to have a separate subsidiary book for such goods in order to clea distinguish between sale and sale on approval.

The auditor should vouch such goods sold on approval with the agreemen correspondence with customer, invoices etc. These goods are to be such in t Balance Sheet at cost or market price whichever is lower, as the 'Goods w customers'. Provision for damages to these goods, if any, should also be made

Goods Sent on Consignment

A trader having large establishment may decide to appoint agents or consign at different places for effecting sale of goods. Goods which are sent on consignme to different places be sold by the consignee at the instruction and risk of t consignor, cannot be treated as sales until these are actually sold by the consigne Such goods shall be created as stock with the agent. Where the number consignments is large consignment ledger having accounts for each individual consignment should be maintained. Each individual consignment will be debited with cost of goods and expenses incurred by the consignor and consignee.

The auditor should check the entries in consignment account with the consignment note, account sale, vouchers for expenses and cash book. The agreements with the consignees for terms and conditions are always to be looked to. Entries for sale proceeds, expenses incurred by the consignee, his commission, etc. shall be vouched with the help of account sale sent by the consignee.

At the date of the Balance Sheet any goods remaining unsold shall be shown in the Balance Sheet as Stock on Consignment and such goods are to be valued at a cost plus proportionate expenses incurred by the consignor or consignee till it reaches the godown of the go down by the Consignee. If marked price of such goods has fallen, then these goods should be valued at market prices.

Where the consignee is paid delcredere Commission, the auditor, should see that bad debts, if any, are met by the consignee and not by his client. In case goods have been invoiced at sale price, he should see that proper unloading has been made in this respect, so that goods are shown at cost price only. The auditor should instruct his client to make proper allowance for goods damaged in transit.

Packages and Empties

In some cases customers are supplied with containers and packages i.e. bags, crafts cans and jars etc. which the customers have to return to the suppliers. The auditor should see that an effective system exists to record such packages and empties. Generally a memorandum system is adopted. Under this system the customer is debited with the cost of such packages and credited where they are returned. The cost of empties is not included in sales. They are entered in the Sales Return Book under a separate column called as 'packages and Empties'. They should also be recorded by the Gate Keeper in the 'Empties Returns Inward Book'.

At the date of the Balance Sheet a list of empties not returned by customers should be prepared and the value of such empties should be recorded in a separate book known as 'Empties and Packages on hand' at cost price less depreciation.

Some suppliers like gas companies maintain separate accounts for each of the containers. A fixed amount is taken as deposit from such customer and amount received is credited to these separate accounts. If a customer refuses to return the containers his deposit amount should be adjusted accordingly.

Auditor has to ensure that proper provision is made for depreciation in respect of Empties and Packages in hand and with customers.

Sale Under Hire Purchase Agreement

In order to increase sales of costly items, traders allow hire purchase facility to customers in respect of which system the price may be paid by the purchasers in a number of installments. Technically, there a difference between a sale under installment system and a sale on hire purchase basis. Under the installments payment system, ownership or title in the goods passes immediately at the time of the contract and on payment of the first installment. Under sale on hire-purchase basis title in th goods is not passed until the last installment has been paid. Thus under the hire purchase system goods can be recovered if any installment is not paid.

NOTES

In actual practice such distinction is seldom made. Two practices are usuall adopted to credit the sale proceeds. One is to debit the total cash price in the yea of sale and to treat the buyer as debtor to the installment not yet due. The other is t take credit only for that amount which have become due. The second method i better, because the profit on sale is equitably distributed over the whole perio during which these installments are payable. Again, under this method profit which has not yet been realized is not taken into account. If this method is followed the auditor should ensure that the amount of unpaid installment is shown as 'Stock or Hire' or 'Stock on Hire Purchase Account'. In case the first method is followed provisions should be made at the date of the Balance Sheet for an amount equal to the unrealized portion include in the installment remaining unpaid.

Vouching of Journal Transactions

It is desirable to have subsidiary books like Cash Book, Purchase Book Sales Book, Purchases Returns Books, Sales Return Book, Bills Receivable Book Bills Payable Book to save time, energy and cost. The use of number of subsidiary book still depends upon the nature of transactions of an enterprise. Journal is used to record all the item which cannot be passed through any subsidiary books. The following transaction are generally recorded through the journal :

1. Opening entries
2. Closing entries
3. Adjusting entries
4. Entries for the issues and allotment of shares and debentures.
5. Entries for making calls on shares and debentures,
6. Entries for the forfeiture of shares and the reissue of forfeited shares.
7. Entries relating to consignment and dishonour of bills,
8. Entries for the acquisition of various assets and liabilities

There are greater chances of fraud in respect of journal entries. Hence the auditor should be careful while vouching journal transactions which are of varied nature. He should see that narration is given after each entry for clear understanding. Documentary evidence for vouching the journals will depend upon the nature of transactions.

Opening entries shall be vouched with reference to last year's audited Balance Sheet. In case of new business, the same shall be examined with reference to purchase issued by the payee, documents of title, minutes of the Board of Director meetings etc.

Closing entries are passed at the end of accounting period when final accounts are prepared. Balance in the nominal accounts are transferred to Profit and Loss Account. The auditor should see that these accounts have been properly valued.

Adjusting entries in respect of prepaid or outstanding expenses and incomes are often made at the end of the accounting period. Also provision for doubtful debts, depreciation, reserves etc. are passed through the journal entries. Auditor should carefully check these items with the relevant accounts. He should see that proper distribution is made between revenue and Capital transactions.

Entries for the issue of shares, their allotment, forfeiture, re-issue, etc. should be vouched with the copies of allotment letters, Shareholders Registers and Minutes Books. Likewise entries in respect of transactions relating to other activities should be vouched with original records, minutes book of Board meetings. The auditor should pass the entries only after he is fully satisfied with documentary evidences.

Bought Ledger

Individual creditors from whom goods are purchased on Credit will show Credit balances. The accounts all sum Creditors are shown in one ledger account, known as Bought Ledger or Purchase Ledger. When credit purchases of goods take place, these are recorded in the books of original entries i.e. Purchases Book or Purchases Journal.

The opening balance of Bought Ledger is vouched with the closing balance of Bought Ledger of previous year. The auditor should vouch Bought Ledger account with Purchases Journal, Purchases Return Book, Bills Payable Book, allowances allowed by creditors, Cash Book, Schedule of Creditors and statement of accounts received from Creditors. For entries of special nature, the journal may be referred to by the auditor. The auditor should cast the accounts in the Bought Ledger with the balances as shown in the schedule of Creditors.

If the ledgers are maintained on self-balancing System, the total balance of the total schedule Creditors should agree with the balance shown in the corresponding creditor's Ledger account in the General Ledger.

Sometimes the schedule of creditor's balance as revealed by the books of account does not tally in the statements received from creditors. This may be due to the fact that goods sent by such creditors might be in transit and might not have been received by the client by the time the book were closed or the schedule of creditors was prepared. The auditor should see that such books are not included in Stock Book or Purchases Book. Sometimes the Schedule of Creditors balance of the statement of accounts received from creditors does not tally due to dispute in some accounts. The auditor instructs his client to make provision for such contingent liabilities and if provision has been made but found to be inadequate, further provision should be made.

Sometime bought Ledger may show a debit balance instead of the normal credit balance. This may be return of goods to creditors for which payment might have already been made. This may be for advance payment made to creditors against which goods have not been received. The auditor should ascertain about the authenticity of such debit balance and if he is satisfied about it, such balance should be shown on the asset side of the balance sheet rather than shown as deduction from Sundry Creditors.

Sales Ledger

Individual debtors to whom goods are sold on Credit will show balances. T accounts of all such debtors are shown in one Ledger account, known as Sa Ledger or Sold Ledger or debtors Ledger. When credit sales of goods take pla these are recorded in the books of original entry i.e. Sales Journal.

NOTES

The opening balance of Sales Ledger is vouched with the closing balanc Sales Ledger of previous year. The auditor should vouch Sales Ledger acco with Sales Journal, Sales Return Book, Bills Receivable Book, Allowances customers, Cash Book, Schedule of Debtors and statement of accounts recei from debtors. For entries of special nature the auditor should refer to the journal v narration. The auditor should cast the accounts in the Sales Ledger with the balan as shown in the schedule of debtors.

If the ledgers are maintained on the Self Balancing System the auditor sho see that the total of the balance in the schedule of debtors as ascertained f each ledger agrees with the total balance as shown in Debtor's Ledger Adjustm Accounts in the General Ledger.

Sometimes the Schedule of Debtors balance as revealed by the book account does not tally with the statement received from debtors. The auditor sh ascertain the reasons for the same. One of the fundamental duties of an audit to see that proper provision has been made by the client for bad and doubtful de If such, provision is inadequate according to his opinion, the auditor should ins his client to raise the same or the report the same in his report if his client doe agree for the same.

If the auditor finds that there is a bonafide credit balance in the Sales Le this should not be deducted from sundry debtors, rather shown on the liabilities under the heading 'Advance against Goods on Order'.

The auditor should be careful about the amount of bad debts written off possible that after the amount has been written off it is subsequently receive misappropriated. To check this type of fraud, auditor should see that the bad are written off only after they have been properly sanctioned by some respon officer.

Total Accounts and Sectional Balancing

In big business concerns where there are large number of transactions, be difficult to prove the accuracy of the balances of Bought Ledger and sales Le To facilitate this 'Total Debtors' and 'Total Creditors' accounts are usually prep The 'Total Debtors' and 'Total Creditors' accounts will contain all the items appe on the Debit side and Credit side of the accounts in the Sales and Purch Ledgers.

If the concern maintains the ledgers on the self-balancing system the cha of errors and frauds decrease substantially. The auditor in such a case should a few test checks and if he finds that there is no mistake in the transactions exan he may presume that rest of the transactions might be alright. But if anything wrong because of test check adopted by him, the auditor remains responsib

NOTES

Summary

1. Purchases of goods are made either on Cash or on Credit.
2. The auditor should vouch the credit purchases with purchases requisition or orders indents, Invoices, Gate Keepers' Goods Inward Book, Delivery Notes, Stock Register, Statement of Accounts from Creditors etc.
3. credit sales can be vouched with orders, received, invoices outward, Gate Keepers' outward Book, delivery Notes. Stock register, statement of Accounts from debtors etc.
4. journal proper may be used for all those entries which are not recorded in any of the subsidiary books. Such journal can be vouched by the auditor by referring to the nature of transaction.
5. Auditor has to pay special attention to peculiar items like Goods Sold on Sale or Return, Goods sent on Consignment, Packages and Empties, Sale under Hire Purchases Agreement etc.
6. While vouching Bought ledger the auditor should examine Purchases Journal, purchase Return Book, Bills Payable Book, Allowances, Cash Book, Schedule of Creditors and statement of Accounts received from Creditors.
7. The auditor should vouch Sales Ledger with Sales Journal, Sales return Book, Bills Receivable Book, allowances to customers, Cash Book, Schedule of Debtors and Statement of Accounts received from debtors.
8. Where number of transactions is very large, total debtors account and total creditors account are prepared to avoid difficulties. If Self-balancing ledger system is followed by the concern, the auditor may rely on test check system.

Model Questions

1. Explain the points you shall consider as an auditor while auditing Credit Sales.
2. Suggest a system of internal check as regards credit Purchase and discuss the duty of an auditor in vouching credit Purchase.
3. For what purpose is the journal used ? How it is audited?
4. As an auditor how do you vouch the following :
   a. Sales Return
   b. Goods sold on Hire Purchase Agreement
   c. Goods sold on Sale or Return basis
   d. Purchase return ?
5. What is meant by Bought Ledger ? As an auditor how would you vouch Bought Ledger and sales Ledger ?

2.11 VOUCHING OF IMPERSONAL LEDGERS

Introduction

In the previous chapters, the duties of the Auditor in relation to the examination of Cash Transactions and Personal Ledgers have been elaborated. Now it is

proposed to deal with the impersonal ledger and the duties of the auditor in vouc
the transactions in the impersonal ledger which affects the Profit and Loss acc
and the Balance Sheet of a concern.

NOTES

Ledger Accounts may be divided primarily into two classes : Personal
Impersonal.

Personal accounts record dealings with persons from whom goods
purchased or to whom the goods are sold. Such transactions are recorded i
Bought Ledger and Sales Ledger respectively. However a certain numb
personal accounts are maintained in the impersonal ledger such as Partner's C
accounts, Loan Accounts, and Current Accounts etc.

Impersonal Accounts record such business transactions which affec
business and not persons. These accounts are divided into two type – Nomina
Real. Nominal Account relates to those aspects which affect (i) Profit and
Account and (ii) Income and Expenditure Account. Real Accounts are conce
only with the assets. So the impersonal Ledger should contain both nomina
real accounts.

The term impersonal ledger is not always used. Impersonal ledger is
called general ledger or nominal ledger. If the accounts in the ledger are not c
it is natural that profit and loss account and the balance sheet cannot exhibit a
and fair view of the state of affairs of a concern. As a result the auditor will s
false report. Spicer and Peglers have rightly mentioned that 'one of the commo
methods of concealing manipulations in personal accounts being to ma
corresponding fictitious entry in an impersonal account".

It is the main duty of the auditor to examine the impersonal ledgers thoro
and detect frauds. The auditor must examine and vouch the following exhausti

i) Posting from subsidiary books to the impersonal ledger.

ii) Posting from cash book to impersonal ledger.

iii) Casts of the various books of prime entry.

iv) Totals in their respective accounts in the impersonal ledger.

v) Posting form ledger.

vi) Particulars recorded in the Cash Book .

vii) Posting of Balances of the impersonal ledgers to this trial balance.

viii) Adjusting entries in their respective accounts.

Outstanding Assets and Liabilities

The audit of the outstanding assets and liabilities in the impersonal le
needs greater attention of the auditor. A schedule of all outstanding assets
liabilities for the period in question should have been maintained in a book c
outstanding memorandum Book.

All adjusting entries must be passed through the journal to arrive at the
or loss correctly. However the Memorandum Book shall be of immense help t

auditor if it is properly maintained and duly certified by a responsible officer. But this cannot relive an auditor of his greater responsibility to check them in examining such books. It is through his experienced and expected knowledge that non-existence and suppression of certain outstanding liabilities by way of manipulation can be detected by the auditor.

NOTES

Outstanding Assets

Outstanding assets are broadly divided in the three categories.

a) Income Receivable

b) Prepaid Expenses

c) Deferred Revenue Expenditure

Income Receivable

Income receivable is an amount which has accrued to the business concern but has not been received. Accrued means the concern is legally entitled to receive the income. The following categories of Income are said to be accrued but not received.

1. Rent Receivable : Rent might have been accrued but the tenant might not have paid it.
2. Dividend Receivable : The Company might have declared dividends on the shares but the shareholders might not have received them.
3. Interest Receivable : The debtor might not have deposited the last installment of interest on the day of closing the accounts.
4. Commission, Royalty, Taxes Claimed, Rebates receivable :

Incomes on commission, royalty, bates etc. might have accrued or might have been due but it has not been received at the date of closing the accounts. The auditor must pay full attention to see that such incomes receivable, due or accrued are duly taken into account in arriving at correct profit or loss. Incomes receivable which are doubtful in nature should not be credited to the profit or loss account. Sufficient provisions should be made for doubtful debts, repairs, irrecoverable arrears while taking incomes receivable into account.

Prepaid Expenses

Johnson defines 'Prepaid expenses as unconsumed services'. There are certain expenditures which a business concern is bound to incur but necessarily for the period under audit. Such expenses are called prepaid expenses. The amount so paid relating to the period subsequent to the date of balance sheet should be carried forward. Such expenditures are working capital. They should be excluded from the profit and loss account but be shown in the balance sheet as assets. Examples of prepaid expenses are.

Insured Premium Paid In Advance

Insurance premiums are generally payable in advance and considerable account is paid in case of large business. The proportionate expenditure on

insurance for the period should be included in the profit and loss account and s
portion subsequent to the date of closing accounts should be calculated and sho
as prepaid expenses as an asset in the balance sheet.

Rents, Rate etc. Paid in Advance

Sometimes rents and rates are payable in advance. Where such expens are considered as current assets and after making apportionment of su expenditure, the prepaid portion should be placed on the asset side of the bala sheet.

Advertising

Payment of advertising made in advance shall be apportioned for any pe subsequent to the date of Balance Sheet and should be carried forward and sh as an outstanding asset in the Balance Sheet. Stock of advertising materials s as posters samples, boards etc. should be valued at cost and carried forward a asset with provision for depreciation.

Prepaid Commission

The salesmen commission agents are sometimes allowed to over c commission on future earnings. Care should be taken by the auditor to find ou prepaid commission which should be properly adjusted in the Profit and Accounts and be carried forward as in the Balance Sheet.

Prepaid Interest and Discount

Sometimes interest and discount are paid not for the accounting perio for a period subsequent to the date of Balance Sheet. Such prepaid interes discount are not the expenditure of the accounting period and hence shou carried forward and shown as an asset in the Balance sheet.

Deferred Revenue Expenditure

There are certain cases of expenditures which are primarily of revenue n but the benefit derived out of it is spread over a number of years. Such expend are conveniently termed as deferred expenditure.

Following expenditures come under deferred Revenue Expenditure:

1) Heavy expenditure of advertisement.
2) Development expenditure in the case of mines and plantation.
3) Research expenditure.
4) Experimental expenditure.
5) Alternation to plant and heavy repairs expenditures.
6) Discount on issue of debentures.

The whole of such expenditure should not be debited to profit and loss ac Only a portion charged and the unwritten portion of deferred revenue expe would be shown on the assets side of the Balance Sheet.

NOTES

Advertisement

Abnormal heavy expenditure on advertisement is incurred to popularize a new article or a new establishment. Such expenditure is capitalized and spread over a reasonable period. Only that portion of expenditure which is written off for the accounting period should be charged to profit and loss account and the Balance shall be shown as an asset until it is completely written off.

Preliminary Expenses

With the formation of a company heavy preliminary expenditure is incurred for promotional steps in the forms of rent, rates, salaries, wages, licenses fees, etc. and the amount should be written off over a short period of years. Current expenditures incurred after revenue earning stage shall be charged to Profit and Loss Account.

Alternation to plant and heavy Repair Expenditure

In order to improve or modernize plants and machinery heavy expenditure may be incurred. The expenditure must be carried forward and written off over a short period of years.

Research Expenditure

Heavy expenditure is incurred on research, the benefit of which is spread over a number of years in future. So the expenditure should be shared over a short period of years and the unwritten portion should be carried forward and shown in the Balance Sheet as an asset.

Outstanding Liabilities

It is the duty of an auditor to see that all liabilities current or outstanding have been brought to books of accounts. Otherwise actual profit or loss cannot be ascertained. If the outstanding liabilities are not included in the profit and loss account naturally dividend to shareholders may be paid, out of capital. In such case the auditor shall be held personally responsible for negligence of duty and be asked to compensate as was held in the case Web Minister Road Construction and Engineering Company Limited, 1932.

The auditor should get a certificate from the responsible officer concerned that all outstanding liabilities have been brought into the account and there is nothing left out. However the auditor is advised scrutinize normal accounts like wages, salaries, interest, discount, taxes etc. and ascertain whether all expenses incurred during the accounting period are accounted for or not. Some of the outstanding liabilities may include.

(i) Unearned income

(ii) Unpaid expenses

Unearned Income

Income might have been received but not earned or due and not applicable as income for the current year under audit. This income is genuinely not income but is a liability. Such income shall not be credited to the Profit and Loss Account but

shall be shown as a liability in the Balance Sheet. The auditor can exam
related vouchers and find out the profit relevant to the period.

Unpaid Expenditure

NOTES

Expenditures which are due or accrued but have not been cleared ar
unpaid expenditures. These expenditures must be included in the Profit a
Account and shown in the balance Sheet as liabilities. Some of the
expenditures are :

(i) Wages and Salaries

(ii) Freight and Carriages.

(iii) Purchases.

(iv) Rent, Rates, Taxes, Electricity, water etc.

(v) Audit Fees.

(vi) Travelers' and agents' commission.

(vii) Interest on loan and debts.

Wages and Salaries

Wages and salaries are generally paid on the 1st day of the followin
when accounts are closed on the last date of the said month. So it is natural
account say not include such expenditures. The auditor should ascertain th
outstanding wages and salaries are adjusted in Profit and Loss Account and
in the Balance Sheet as liability.

Freight and Carriages

The forwarding and clearing Agent does not send the Freight and C
charges. Commission, in time so as to be included in the current year's expe
It is the duty of the auditor to verify that such expenditures are really being c
to the Profit and Loss Account and shown as Outstanding liabilities in the E
Sheet.

Rent, Rates, Taxes, Electricity, Water, Telephone etc

The bills for Rents, rates, Taxes, Electricity, Water etc. come much late
period. Such expenditures are due and must be included in the Profit ar
Account to ascertain the true profit or loss and should be shown as liabilitie
Balance Sheet.

Commission

Commission is paid on the sale submitted by the agent and salesman.
cases, calculation of commission payable to them takes time and may b
after account period is closed. Sometimes the agents are allowed t
commission in advance or to deduct their commission from the sale proceed
these cases proper account on commission should be calculated and ch
not brought to the books of the account. The Profit and Loss Account sh
debited for commission for the period and outstanding amount should be s
the Balance Sheet.

NOTES

Purchase

At the close of year the goods may be purchased and relative invoices may not be received in time. A schedule of such purchases may be prepared and credited to outstanding liabilities account thus debiting the purchase account. Such outstanding liability should properly be accounted for.

Audit Fees

Audit fees are paid after the audit is over. But audit on the Balance Sheet shall be over much later than the day of closing the accounts. However the audit fees are one of the normal expenditures and should be included in the profit and loss account and shown as liability in the Balance Sheet.

Interest on loan and debts

The Interest on loan and Debts if not paid on or before the date of the balance sheet should be calculated from agreement and verified. Such outstanding interest shall be debited to Profit and Loss Account and shown as Liability in the Balance Sheet.

Contingent Liabilities

A contingent liability is one which may or may not become a liability on the happening or non-happening of an event in future. Prof. W.B. Meigs defines contingent liability 'a potential liability which either will develop into a full-fledged liability or will be eliminated entirely by a subsequent event". A contingent liability may or may not necessitate the payment of money.

Contingent liabilities may be of two kinds :

i) A liability involving an ultimate loss.

ii) A liability in the acquisition of an asset of corresponding value.

Liability Involving Ultimate Loss

In case of litigation, guarantee by the company in raising loan and over-drafts, speculated transaction, forward contract the company may have to suffer a loss which could not have been determined.

Liability in the Acquisition of an Asset of Corresponding Value

In case of a writ the client may get the decree for acquiring an asset for which an asset of corresponding value may have to be acquired.

The other kinds of contingent liabilities are discounting of bills of exchange and damages for breach of contract, infringement of a patent, copy rights etc.

The auditor will have to observe the rules prescribed in part one of Schedule VI of Companies Act regarding contingent liabilities. The auditor should mention the following notes.

i) The liabilities in respect of which a provision has been made in the Balance Sheet.

ii) The liabilities in respect of which no provision has been made in the Balance Sheet but a note has been given at the foot of the Balance Sheet.

NOTES

Contingent Assets :

The Companies Act requires contingent liabilities to be mentioned in t Balance Sheet but remains silent about the declaration of contingent assets. T contingent assets include refund of taxes and octori fees, the legal action infringement of copy right, and uncalled share capital of a company etc. It is the d of an auditor to present this fact at the foot note of the balance sheet.

Allocation of Expenditure Between Capital and Revenue :

Capital Expenditure

Capital expenditures are incurred in acquiring assets for the purpose of earni income of increasing the earning capacity of the business. All such expenditu which are in the nature of increasing the earning capacity or increasing the life of asset or acquiring a valuable right or purchasing a new property are capi expenditures. The example of capital expenditures are purchase of moderniz machines; construction of sheds, purchase of lorries to replace horse, ca development of plantation, copy rights etc.

Revenue Expenditures :

Revenue expenditure is that expenditure which is incurred in carrying business and in maintaining the capital asset or to maintain the revenue earn capacity of the business.

Revenue expenditures may be classified into four categories :

i) Expenditures for conduct and administration of business of goods like Salari Rent, Taxes, Postages, Electricity etc.

ii) Expenditure in distribution of goods like Commission traveling expens Samples, etc.

iii) Expenditure in maintaining the value and life of an asset, ordinary repa lubrication.

iv) Expenditure in earning revenue-purchase of goods for resale.

Distinction Between capital and Revenue Expenditure :

There may be expenses which cannot be properly allocated between cap and revenue expenditures and wrong allocation will lead to the preparation c wrong Profit and Loss account which may result in declaration of dividend paya out of capital. Consequently the directors will be held responsible for such ille payment. Wages in the ordinary course of business are revenue expenditures wages paid in the installation of machine or erection on building shall be a cap expenditure. So in the latter case instead of charging to profit and Loss Account machinery account should be debited and the general wages account should credited so that the Profit and Loss Account shall not be unduly burdened with s huge expenditure. Similarly expenditures on repairs, installation of new machin carriage paid for new machinery, interest paid during construction of work, le charges paid in purchase of a building need proper allocation and will be conside as capital expenditure; whereas carriage expenses or interest on debentures s be classified as revenue expenditure and charged to Profit and Loss Account.

The auditor should be careful to note that whenever any expenditure has been classified as capital expenditure he should satisfy himself to the fact whether such expenditures are either –

i) For acquiring fixed assets or

ii) For increasing the earning capacity of the existing assets or

iii) Improving the life of the existing assets.

It is the duty of the auditor to get a certificate from a responsible officer to the effect that proper allocation of expenditure between capital and revenue has been made.

NOTES

SUMMARY

1. Ledgers accounts may be divided primarily into two classes: personal and impersonal.
2. Impersonal ledger contains whole of accounts affecting composition of trading, Profit and Loss Account and all accounts representing assets and liabilities other than those contained in the personal ledger.
3. Care should be taken by the auditor to ensure the inclusion of outstanding liabilities and assets.
4. Outstanding liabilities include unearned income and unpaid expenses.
5. Outstanding assets include income receivable, prepaid expenses and deferred Revenue Expenditure.
6. Wrong allocation of capital and revenue expenditures shall affect the preparation of a correct Profit and Loss account and the Balance Sheet.
7. Capital expenditures are for the increasing of earning capacity of the business, or for acquiring new assets for extra income.
8. Revenue expenditures are incurred to maintain revenue earning capacity of the business.
9. Contingent liabilities are dependent on the happening of a future event. It is a possible future liability.

SELF TEST – 7

1. What is meant by outstanding asset and outstanding liabilities ? Explain the duties of the auditor with regard thereto.
2. Explain the meaning of deferred revenue expenditure. Give example and describe the auditor's duty with regard to this item of expenditure.
3. What are the contingent liabilities? What are the requirements as per Companies Act with regard to contingent liability while preparing a Balance Sheet?
4. Distinguish between capital expenditure and revenue expenditure and indicate why this distinction is important ?

5. What principles should be applied in allocating the following expenditures between capital and revenue ?
   i. Wages for creation of a building.
   ii. Repairs to Plant and Machinery.
   iii. Renewals of licenses.
   iv. Heavy Advertisement expenses.

NOTES

2.12 VERIFICATION OF RESERVES AND PROVISIONS

The Companies Act, 1956 has clearly defined Reserve, Provision an Liabilities. (See Clause – 7, Part – III Schedule VI)

Reserve :

The term reserve shall not include any amount written off or retained by way providing for depreciation, renewals of diminution in value or retained by way providing for any known liability.

Provision :

Provision has been defined as any amount written off or retained by way providing for depreciation, renewals or diminution in value of assets or retained way of providing any known liability of which the amount cannot be determined w substantial accuracy.

Capital Reserve :

But the expression "Capital reserve" shall not include any amount regar as free for distribution through the profit and loss account and the expression 'reve reserve' shall mean any reserve other than capital reserve.

So it is very clear that the term reserve should be used to describe the am set aside out of profits and other surpluses which are not designed to meet liability or contingency. The amount is retained in the business as part of the ca

The term provision is used to describe amount set aside out of profits to specific liabilities and any diminution in the value of assets.

Duty of an Auditor in Respect of Reserve :

The adequacy or otherwise of amounts set aside form profit to reserv matter of little importance to the auditor. But he may be called upon to advise the amount to set aside to reserve. Further his opinion may be sought as nature of investment of the reserve.

If there is need of additional working capital which can be fruitfully emplo the business then it is sound to retain such reserve inside the business. I cases instead of taking a loan and paying interest, it is better to utilize the a since this will result in higher return to the undertaking.

But if the reserve cannot be fruitfully employed inside the business it is to invest such amount outside which will mean a source of considerable str

Where the reserve is invested outside the business it is called reserve

NOTES

Kinds of Reserve :

There are five classes of reserves (a) General reserve (b) Sinking fund (c) Reserve Fund (d) Capital Reserve (e) Secret Reserve (f) Specific Reserve.

General Reserve :

General reserve is also called revenue reserve. This reserve is created by setting aside a sum out of profit to provide additional working capital in the business or to equalize dividend or to meet any kind of unknown contingency. It is created strictly out of profits only.

Sinking Fund :

Sinking fund is a kind of reserve. The purpose of creating a sinking fund is to reduce liability like repayment of a loan or redemption of ventures, to replace an wasting assets i.e. mines, quarries, to replace depreciating assets, to renew a lease.

The sinking fund is created out of funds by debiting Profit and Loss appreciation account if the purpose of the fund is to provide for repayment or redemption of liability whereas it is chargeable to Profit and Loss account if the purpose is replacement of assets. In case of repayment of liabilities the sinking fund must be created out of Profits only but in case of replacement of an asset the profit and loss account must be debited with the amount, whether there is profit or loss. Alternatively an endowment policy may be taken and the insurance company will pay on maturity an amount sufficient to meet the requirement. Sinking fund amount must be invested every year in gilt edged securities. The amount to be set outside annually to meet the loss or replacing the wasting assets after a particular period can be known from the compound interest annuity tables.

The duties of an auditor with regard to audit of sinking fund is that he can ensure for creation of a sinking fund in a Company if it is laid down by the Articles of Association or the debenture trust deed.

Reserve Fund :

Reserve should not be confused with reserve fund. Reserve is synonymous with general reserve. If the reserve amount is invested outside the business in gilt edged securities so as to be readily realizable, it is called reserve fund.

Capital Reserve :

A Capital reserve is one which is created out of profit. This reserve cannot be legally distributed amongst the shareholders. It is created to meet capital losses. The capital reserve is created out of profit of capital nature, some examples of which are given below :

1. Appreciation in the value of asset.
2. Sale of the fixed asset at a price higher than the book value.
3. Premiums on issue of shares and debentures.
4. Profit of an exceptional nature.
5. Profit in purchase of new business.

6. profits prior to incorporation of a limited company.
7. Surplus in the share forfeiture account.

The capital reserve may be utilized (1) in issue of bonus share (2) In w
fictitious assets like good will, preliminary expenses etc.

NOTES

Auditors duty in connection with capital reserve :

It is the duty of an auditor to see that the amount transferred to a capital res
account is really the surplus capital over assets and liabilities, and capital re
has been utilized according to the Article of Association. Capital reserve m
distinctly shown in the balance Sheet, and should be distinguished from re
reserve account. Capital resource be distributed as dividend (a) if it is permit
the Articles of Association (b) the surplus is realized (c) the surplus remain
revaluation of assets.

Specific reserve :

The specific reserve or provision amounts to setting a reserve to meet a
contingency or liability at a future date. The sum must be set aside if busin
running at a loss. This has been discussed at length under provisions.

Secret Reserve :

Secret reserve has been defined as any reserve which is not shown
face of the balance sheet. This reserve is not mentioned any where in th
account. This reserve is created by the following ways :

1. Under-valuing the assets.
2. By providing extra amount in reserve than necessary to meet bad and d
debts.
3. By providing excessive depreciation.
4. By inclusion of fictitious liabilities.
5. By over-valuing the liabilities.
6. By charging capital expenditure to revenue expenditure.
7. By showing contingent liability as real liability.

A secret reserve is created to meet extraordinary loss or to suppress th
of business prosperity without disclosing to the shareholders or public o
competitors. The other purposes of creating secret reserve is to equalize d
rates in the event of loss.

Objections to creation of secret reserve :

1. Serious allegations are made in the creation of secret reserve on the fo
grounds :
   (a) The balance sheet does not exhibit true and fair view of the
   affairs of the company.
   (b) The shareholders who are owners of the company do not g
   legitimate share of profits.

(c) The directors manipulate, misappropriate and indulge in speculative transactions at the cost of the shareholders' interest.

(d) The company gets less amount from insurance company in case of the fire because of under valuation of assets.

(d) The directors conceal their inefficiency and negligence and in case of loss they draw out from secret reserve.

NOTES

Secret Reserve and Companies Act :

The Companies Act has prohibited the creation of secret reserve in all kinds of companies except banking insurance, finance and electricity companies.

Duties of an auditor in connection with the secret-reserve :

In order to give a clear report on Profit and loss Account and Balance Sheet the auditor is to see that nothing has been concealed in the report. The auditor shall have to disclose the creation of secret reserve in case of Banking, Insurance Companies etc. The auditor should enquire the honesty of the purpose for creating secret reserve. If he finds that the intention is very clear and honest he may mention that the value of assets is understated since the auditors' responsibility's to certify a Balance Sheet that it represents true and fair view of state of affairs of the company is prohibited to create a secret reserve.

Provision :

A Provision is made where loss is anticipated but the amount is unascertained. The expected loss contingency is known and specific reserve is made to meet such liability at a future date. So it is a charge against revenue, the profit and loss account being debited and provision account being credited.

The provisions are made with the following objectives : - (a) to meet a known loss (b) to meet an expected contingency (c) to meet an outstanding liability.

Provision for Maintenance :

Provision for maintenance comes under a known loss. If the cost of maintenance like repairs, renewals of parts vary from year to year it is desirable to create a provision for maintenance.

Provision for Bad Debts :

It is the duty of the auditor to ascertain whether any of the individual balances represent debts which are unrecoverable or of a doubtful nature that some provisions for possible loss should be made. But it is not his duty to make provisions. He has no powers to do so. But if he finds that the provisions are insufficient; he can make a reference in his report.

Provision for Discount :

Provision for providing cash discount on outstanding creditors may be made. It should be charged against the period in which the use of money is received. The auditor should however consult articles, minute books, and orders of the directors.

Provision for Depreciation :

NOTES

Provision for depreciation is a must so that the original capital invested in t assets can be recouped to substitute the new assets in place of an old one whi has become valueless, by reasons of wear and tear or effluxion of time obsolescence or exhaustion. The depreciation fund may be invested either in t business or outside the business in gilt edged securities according to the merit

SUMMARY

1. Reserve is the part which has been set aside to meet a known or unkno contingency liability, demunition in the value of asset.
2. A provision is made where a loss or contingency is anticipated but must created irrespective of a profit or loss in the business.
3. Reserve fund is a reserve which is set outside the business in gilt edg securities.
4. The auditor's duty in respect of different kinds of reserves are very intrigu and typical. He should follow the guidelines given by the Companies Act.
5. Secret reserve is a reserve which is not apparent on the face of the Bala Sheet. It is called hidden reserve or inner reserve or internal reserve.

MODEL QUESTIONS

1. What do you understand by the following and what are the duties of an au in respect of terms :
   a. Reserve fund
   b. Reserve
   c. Depreciation fund
   d. Capital reserve
   e. Sinking fund
2. What do you understand by secret reserve ? how are they created in the b of limited companies ? What are the duties of an auditor in this matter ?
3. What is difference between reserve and provision ?
4. Show the difference between reserve and reserve fund and suggest whe reserve fund should be invested in outside securities ?

Verification and Valuation of Assets

There is no need to emphasize the point that any part of the audit proc carried out with a view to correctly ascertaining, as far as possible the fin position of the business concern, Be it checking or vouching, all are meant f same purpose. Similarly, the verification and valuation of assets and liab appearing in the Balance Sheet form a very important part of the audit proces the duties of the auditor there to is of maximum care and caution. The auditor th checking or vouching of books of accounts can determine the arithmetical acc of transactions and thereby he confines himself to what have been mentioned books of accounts and their correctness. The vouching of books would only tell that a particular asset ought to exist but it cannot prove whether the asset really exists or in the possession of the concern at the date of Balance Sheet. Possibility is not ruled out so far as a piece of asset might have been acquired, but subsequently it might have been disposed of damaged, pledged or misappropriated. So the fact that there is an entry regarding the purchase of an asset and its entry is correctly recorded is not the conclusive proof that the asset is still in the possession of the concern at the date of Balance Sheet. It is like this situation which calls for the verification of the assets.

NOTES

Verification of assets literally means providing or confirming the existence of a thing and hence it is "an enquiry into the value, ownership and title, existence and possession, the presence of any charge on the assets". The auditor can do justice to his processional requirements, if he, apart form vouching, undertakes a physical verification of assets to find out that the assets which ought to have existed as per the vouching, do exist. If he skips this process of auditing, he fails in his duty and liable for the damages as decided in London Oil Storage Company Ltd. Vs. Hasluck & Co. (1904).

Basic Principles of Verification .

From the foregoing discussion, you might have made an idea as to the meaning of verification and its necessity. The auditor, while carrying out verification of assets must keep the following points uppermost in his mind.

a) The assets appearing in the Balance Sheet do really exist at the date of Balance Sheet. To ascertain it, if possible he must make a physical inspection of the assets.

b) Compare the concerned ledger accounts with the Balance Sheet. It would reveal if, in fact, the transactions pertaining the assets have been correctly taken to the Balance Sheet.

c) The assets were acquired for business and clearly stated so in the Balance Sheet.

d) Values of the assets mentioned in the Balance Sheet are correctly ascertained.

e) The assets are free from any charges or encumbrances.

f) Ownership of the assets lies with concern.

g) The assets are appropriately maintained and preserved.

Valuation of Assets :

Valuation, as a matter of fact, is a part of the verification process. Since verification implies not only an enquiry to the existence of assets but also to their values. Auditing shall fail in its purpose to present a fair picture of concern's financial affairs if assets and liabilities are not properly valued, since an under or over valuation thereof would either depress or inflate profits.

It has been judicially held that an auditor is not a valuer, as he is presumed to lack in the technical knowledge necessary to determine the values of assets shown in the Balance Sheet. As a matter of practice, the valuation of assets is made by the management, and that leaves enough room for the management to manipulate the values of the assets in either ways to their advantage. Since auditor is duty bound to give an honest report to the shareholders as to the actual financial affairs of the firm, he can hardly afford to accept the valuation of assets as made by the management. No doubt, he is entitled to rely on valuation made by persons having necessary technical knowledge but nonetheless he must satisfy himself that the basis adopted by the management for valuation is a sound one. If he had done this much, then he is supposed to have given an honest report on the Balance Sheet. The students should bear in mind that the Balance Sheet is not a valuation statement and the auditor does not guarantee upon it that the assets are shown in their estimated realizable values, if they are offered for sale. Thus valuation, from the auditor's duty point view, implies the critical examination and testing of the determined values o the assets by the auditor on the basis of generally accepted conventions and accounting principles. The auditor, therefore, should take the following steps in the matter of valuation.

NOTES

a) Get all information in this respect.

b) Make a critical examination of values determined by the management.

c) Enquire the basis on which valuation is made and if such basis is in accordanc with the established accounting conventions and principles.

d) Make an enquiry if there is any change in the basis followed from the previo years and reasons there of.

e) Solicit the help of technically qualified persons for the valuation of any particu asset, if he feels the necessity of it.

f) Finally, he makes his own judgment with regard to the values of the assets

Difference between verification and valuation

The students must have marked that there exists a difference betw verification and valuation. In order to understand it properly, the points of differe are separately given below :

a) Verification is broader auditing process of which valuation is a part. Bri verification includes valuation.

b) Valuation is not a part of the auditor's duty. It has been judicially held i Kingston Cotton Mill Co. Ltd. (1896) case that he is not a valuer. On the con verification is an important part of the auditing process and forms a p auditor's duty. Any negligence thereof makes him liable for damages.

c) Determined values of assets are not necessarily their realizable values, i are offered for sale. Valuation is fairly proper if the assets are valued upo basis of their worth as a going concern.

d) Valuation can hardly be exact in view of the charges in the market price assets and due to arbitrary rate of depreciation. But this problem do arise in the case of verification of assets.

Verification and Valuation of Fixed Assets :

Verification does not offer that much of difficulty as the valuation does. The auditor, in order to verify the existence of assets, should inspect them on the date of Balance Sheet, but for the fixed assets his task is comparatively easy. The fixed assets are those of permanent value with which business is carried on and which are acquired and held for the purpose of earning income and not for resale. Fixed assets are mainly land, buildings, plant and machineries etc.

Fixed assets are shown in the Balance Sheet at their cost i.e. prices at which they were acquired, and the total of provisions made to date for depreciation is shown as deduction there from. Rate of depreciation is calculated on the basis of effective life of the asset so that cost is equitably spread over its life span, and the profit and loss account of each accounting period is charged with proper portion of the cost. The method of exhibition of fixed assets at their cost minus depreciation at a fixed rate of percentage has encountered criticisms in the recent past because of fluctuating purchasing power of money. It has resulted in the fixed assets appearing in the Balance Sheet at their values far less than their current replacement values and this further results in the inadequate provision out of profits for replacing assets. Thus the shareholders do not get a true picture of the present value of the assets of their Company.

From the above discussion, the student must have noticed that there exists a controversy as to the prudence of showing the fixed assets at their original cost and depreciation thereon or at their replacement costs. Although there is a strong view in favour of charging depreciation on fixed assets in their replacement costs, the professional bodies recommend that provision for depreciation should continue to be made on the basis of historical cost. The opinion of the Institute of Chartered Accountants in England and Wales in this regard is as follows :

"For the balance sheet purpose, fixed assets should not, in general, be written up on the basis of estimated replacement costs, especially in the absence of a measure of stability in the price level".

But in view of the persisting inflation which is a global phenomenon, it is financially prudent to take to account the replacement cost of the assets and make necessary provision for it. It is suggested, therefore, that any amount kept separate to finance replacement at increased costs of the assets should not be treated as a provision which must be made before the profit of the year is arrived at, but as a transfer to a reserve. This should be treated as specific capital reserve for the enhanced cost of the replacement of the assets. And ordinarily this is not available for distribution of dividend.

Verification of Fixed Assets :

1. ***Land and buildings :***

For the purpose of verification of land and buildings the auditor should call for the title deeds of the land and buildings shown in the books of accounts to ascertain the nature of ownership i.e. free hold or lease hold. He should examine the deeds, but however he is not responsible of the validity of the titles. It is adequate for the verification purpose. If he finds that the title needs for the land and buildings are in the client's name. But to be sure, he can obtain a certificate from the client's solicit as to the validity of the title deeds covering the land and buildings under audit.

NOTES

If the property has been given on mortgage the title deed must be w mortgage. The auditor in that case should obtain a certificate to that effect from h

If the building is in the course of construction, he should verify the debi balance of the asset account by inspection of the architect's certificate and contractor's receipts. If the building is being constructed by the client's own men must obtain certificate from a responsible officer as to the total expenditure incu to date, raw material consumed, wages paid etc. debited to the account. He m ensure that no irrelevant items have been added to it.

In the case of leasehold land and buildings, at the possession of the clien should inspect the lease deed to ascertain the conditions of lease with regard t payments of ground rent, insurance cover for property are duly complied Besides, he should see that any amount paid and expenses incurred for acqu it have been capitalized.

· Sometimes, it so happens that the client might have given land on leas a right to receive from lessee an annual ground rent during the period of lease auditor in this case should examine the lease deed and terms therein. He s check that the rents received during the period have duly accounted for.

Freehold property should appear in the Balance Sheet at cost and acco depreciations should be charged. There is no difficulty for land to show as its c cost, since there is no question of depreciation for it. Buildings, the value of w likely to go up, may be shown at their enhanced value but it is not the usual p

It is suggested that land and buildings should be shown separatel Balance Sheet, since buildings have the provisions for depreciation and t does not have so.

The auditor should also see that there is adequate insurance cove buildings and the premises regularly paid either by the client or by the lea building is leased out.

Further, the auditor must see that if any land and or building have b out during the year, the sale proceeds have been duly accounted for.

2. *Plant and Machinery :*

Although verification of all plant and machineries by physical insp desirable, it is not always feasible. At least, the auditor should make inspection and in the process of vouching, he should satisfy himself existence by comparing the plant register. He should vouch the purchas and machinery with invoices and receipts and must see that all expendit regard have been treated as capital expenditure. Similarly, if any machin sold during the year, he should see that any profit or loss on the accoun duly dealt with. When any machine is scrapped, he must satisfy h appropriate entries are passed in the books of accounts.

The Plant Register will show the cost of each machine purchased and the amount accounted for its depreciation. When the auditor vouches the entries in the financial books relating to the purchase of machinery he should also vouch and compare the corresponding entries in the Plant Register.

The expenses incurred for the installation of plant and machinery should be capitalized. But reinstallation cost should not be capitalized if it is not conclusively shown that the reinstallation results in increasing its yielding capacity. Repairs or replacement of parts of machinery should not be capitalized.

Sometimes plant is revalued for insurance purpose. The auditor should examine the valuation and make enquiry to ascertain the case where revaluation of the plant is less than its book value.

Last, he should see that there is adequate insurance cover for the plant and machinery.

3. *Furniture, Fittings and Fixtures :*

Many firms maintain Furniture Registers recording all such assets. But there are some firms which maintain Furniture Register only for the costly furniture. In that event, items recorded in the Register should be dealt with separately, not merged with General Furniture and fittings Account. It would facilitate the comparison of their costs and depreciation there to as shown in the Register with balance of corresponding accounts at the date of Balance Sheet.

The auditor should verify them with the help of invoices received form the vendors. Any expenditure on their procurement should be capitalized. Any sale, addition, replacement or scrap during the year should be thoroughly examined. He should also examine the system in vogue, to check pilferage of items. If a Stock Register is maintained in the firm, he should inspect it.

4. *Motor Vehicles :*

If the firm has a fleet of vehicles, it is advisable to maintain a register similar to plant register. The assets should be verified with the help of the invoices from the suppliers. The auditor should examine the registration book of each vehicle to ascertain the ownership of the firm. He should note down registration numbers of the vehicles and description from the registration books to check them with the particulars mentioned in the Vehicles' register. He should also examine that the vehicles have been insured.

5. *Patents and Copyrights :*

The auditor should vouch their assets with the help of documents under which patents and copyright have been obtained. He should see that renewal fees have been regularly paid, and receipts there to have been obtained so as to ensure continuance of these rights and these renewal fees have been charged to revenue account. Where the firm has a number of patents or copyrights, he should demand a schedule of these duly certified by an officer of the firm.

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6. Loose Tools :

The verification of loose or small tools by personal inspection is not alway possible. Besides, these are often purchased during the year and many of them ar used and wasted. They have low span of life and low unit of cost. The auditor, whil vouching them, should see that there exists a system of periodic stock taking c small books to prevent pilferage. He should demand a list of tools which have bee wasted during the year and tools which shall be no more in use.

7. Patterns and Drawings :

These are procured by the firm at a cost. Usually the expenses thereto ar charged to the revenue account, but if considerable amount has been spent on the acquisition, it is advisable to temporarily capitalize them. The auditor should examin the vouchers relating to them to verify these assets.

8. Goodwill :

Goodwill is an intangible asset and an account relating to it appears in th books of accounts, where firm has acquired it on payment by way of purchasing th business from some other firm. The auditor should vouch it by examining the purchas agreement wherein the price of goodwill might have been specifically mentioned. I the absence of specific mention of its price it can be ascertained by finding out th difference between the total price paid for the business acquired and the boo value of the net assets taken over. Goodwill usually appears in the Balance Sheet a its purchase price or at purchase price less any amount written off, Since goodwi does not depreciate, it is not necessary to provide its depreciation.

2.13 VALUATION OF FIXED ASSETS

1. Land and Building :

Land unlike buildings is not subject to depreciation and hence is shown in th Balance Sheet at cost. It is always valued at cost, although its value is subject t fluctuation, because such fluctuation does not affect its earning capacity.

But buildings should be valued at their cost plus any capital expenditure incurre for them by way of addition or alteration less the depreciation at a determined rate The auditor should see that expenditure on fittings and fixtures are not added to th building's value and also the value of land on which building stands is not added while charging depreciation. He should further see that repairs to the buildings ar not added to the value.

2. Plant and Machinery :

In the matter of valuation of machinery the original value and the depreciate value are taken into consideration. It is not proper to base valuation on thei replacement value. The auditor should see that adequate provision for thei depreciation has been provided for, but at what rate depreciation should be charge is the lookout of the management. If the auditor feels that provision for depreciatio is inadequate, he can mention it in his report. Further if any machinery has bee acquired on hire purchase or installment basis, he should see that depreciation i charged on its original cost, not on the amount of installments so far paid.

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3. ***Furniture, Fittings and Fixtures :***

Here the valuation is also made taking into consideration their original costs and depreciation so far. Furniture and fittings are subject to greater wear and tear and hence auditor should see that adequate provision for depreciation has been made.

4. ***Motor Vehicles :***

Valuation of motor vehicles should be made as it is done for plant and machinery. Since depreciation on motor vehicles is comparatively quick, the auditor should see that depreciation is charged at a higher rate of percentage.

5. ***Patents and Copyrights :***

While valuing the patents, the auditor should take into account its legal life. The patent is subject to depreciation on account of (a) passing away of time, (b) obsolescence and (c) reduced profit earning capacity of the patented articles. The patents should be written off at the expiry of its legal term, but where patent continues to be of value even after expiry of its term, it would be revalued and in no case its value be written up.

Copyright has no longer life than of patents. Usually it lasts for the life time of the author and 50 years after his death. Since most of the copyrights do not have any value during the greater part of their legal periods, depreciation, therefore, need not be based upon the entire period of copyright, but instead copyrights should be revalued every year and accordingly depreciation be charged.

6. ***Small Tools :***

Small tools are usually revalued every year. Any difference between revalued amount and their original cost is charged to the revenue account. While revaluing the small tools the auditor should see that no worn out useless pieces are included in the valuation.

Verification and Valuation of Floating and Current Assets

Current assets are those which are acquired by the business for the purpose of sale and subsequent conversion into cash. Such assets are stock, book debts, investments etc. The current assets are valued at their original cost or market value whichever is less at the date of Balance Sheet. It is always advisable that the current assets should not be valued at more than their original costs so as to avoid a situation where their market value may fall. This method of valuation insulates the current assets from fluctuations in their market prices.

Briefly, we may say that in the matter of valuation of current assets, a conservative estimate should always be followed. Some of the current assets and how they are verified and valued are given below:

1. ***Stock-in-Trade :***

Stock-in-Trade is an important item of current assets. On their verification depends the correct estimate of the profits of the firm. And again this is an item the value of which can be easily manipulated either to inflate or deflate the value so as to suit the management's convenience and this is why the auditor should exercise maximum caution and care to verify them.

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The nature of the duty of the auditor on verification of stock-in-trade has not been properly laid down. Views differ in this regard. One school advocates that the accountant should carefully ascertain the accuracy of inventories, since correctness of profit largely depends upon the correctness of stock-in-trade. But others feel that the auditor does not have the necessary competency to do that and therefore he should rely upon inventory certificate given to him by the management. Whatever may be the different views in this regard, the fact remains that auditor should apply some suitable checks at discretion to ascertain the accuracy of the inventory figures as far as possible. In this connection, a few legal pronouncements be studied to arrive at the correct position of the auditor as regards verification of stock.

In Kingston Cotton Mills case, 1896, it was held that "it was no part of auditor's duty to take stock", and it is enough for him to rely on the certified figures supplied to him by the trusted officers of the Company e.g. manager.

But, at present, some learned association of accountants feel that the aforesaid decision of 1896 is no longer valid in view of the changed situations. In Thomas Gerrad and Sons Ltd. (1967) case, it was pointed out that complete physical verification of stocks though not obligatory for the auditor, he should do so if there exists scope for the reasonable doubts to the correctness of the inventory figures. The institute of Chartered Accountants of England and Wales is of the view that an auditor is not bound to undertake a complete physical examination of stocks, but where it is practicable and if stock-in-trade is a material factor in the business, the auditor should satisfy himself as to the effectiveness of the application of the client's stock taking procedure. The Institute of Chartered Accountants of India also subscribes to the same view.

In view of the above discussion the auditor should verify stock in the following ways.

(i) He should acquaint himself with stock records and manner of keeping them.

(ii) He should examine the procedure adopted for stock control such as procedures of receipts and issues.

(iii) He should examine the soundness of the procedure for stock taking.

(iv) He should apply some test-checks as to the prices of some items of stock with price catalogues and price quotations.

(v) He should carefully examine to see that no items which do not belong to the client's firm figure in the inventory list.

(vi) He should examine that no asset of fixed nature such as plant and machineries, furniture, etc. are included in the stock list.

(vii) He should obtain a certified stock list from a competent officer of the firm or company.

Valuation of Stocks :

To examine the valuation of stock is the next job of the auditor, and is of considerable importance from effective audit point of view. He should carefully examine the values assigned to each item of stock and enquire about the basis of valuation. If he finds that the basis of valuation has changed from the last year he should ask for explanation to that effect.

The generally accepted basis of valuation of stock is "cost or market price whichever is lower". There are two methods of valuation on this basis known as (i) the pick and choose method, and (ii) the global method. In Pick and Choose Method, enquiry is made to each item of stock's market price and cost and whichever is found less is taken for valuation. But in Global method, the aggregate cost of all items of stock and their aggregate marked price are determined and whichever is found less is taken for valuation purpose.

Although, the above method of valuation has been generally accepted, the valuation of the following goods calls for variation in the method because of their peculiarities.

a) Raw Materials :

Raw materials are purchased by the firm to be used in the manufacture of the goods. These should always be valued at their original cost, irrespective of the marked price. The original cost of the raw materials includes their invoice price and freight changes, duty, octroi tax if any, etc. paid to bring them to the factory. Careful attention be paid to see that no useless raw material is included in the valuation in order to unduly inflate the valuation.

b) Goods in process or Semi-finished goods :

These are the goods in the process of being converted to finished goods. There may be some such products at the date of Balance Sheet. The same finished goods are always valued at cost ignoring their market price. Here the cost includes works cost only i.e. cost of raw materials plus the direct expenditures plus direct works over head expenses. The auditor must check that expenses incurred at factory only are include in the works cost, but no administrative expenses incurred in office are included.

c) Finished Goods :

Finished goods may be of two types (i) where these are purchased for resale, (ii) where these are manufactured in the firm. In the former case these should by valued at the original cost as in the case of raw material. But in the later case, these are valued at cost or at market price whichever is lower.

d) Goods on Consignment :

Unsold goods on consignment are included in the stock and are valued at cost included invoice price of goods plus freight plus all other duties, taxes etc., paid and any charge incurred by the consignor or consignee till the goods reach the go down of the consignee.

e) ***Plantation Products :***

These are tea, coffee, rubber and tobacco. The firms dealing in these product prepare their annual accounts after the disposal of the products and hence instea of valuing these products under the method of "cost or market price which is less value them at their realizable price.

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f) ***Wine, Timber, Rice etc. :***

The peculiarity with these products are that their values increase with th passage of time. Older they are, costlier they become. Hence these are valued above their cost which includes their cost price plus maintenance expenses and reasonable rate of interest on the amount of capital blocked. But in no case, thes should be valued at more than their market price and the auditor should pay h special attention to this aspect.

2. Book Debts :

For the purpose of verification of book debts, the auditor should examine t schedule of debtors with the ledger and the statements received from the debto The Companies Act, 1956 provides that the company must disclose all the secur and unsecured debts and must differentiate good debts from the doubtful deb The classification of debts should be as follows:

a) Secured debts considered good.

b) Unsecured debts on debtor's personal security considered good.

c) Debts considered doubtful debts or bad debts.

Further, the auditor should make searching enquiries, if any debts are due the directors and or any officers of the company either separately or jointly with a other persons. This should be separately disclosed.

3. Bills Receivable :

The auditor should verify the bills in hand with the balance of Bills Receiva Account to find that they are in order. He should also count them in hand. He sho also obtain a certificate from the bank in respect of bills that may be with it collection. Besides, he should pay attention to bills discounted but not matured the date of balance Sheet. These should be shown by means of footnotes a contingent liability. His last duty in this regard is to see that an adequate provis has been made for any bills which may be of doubtful recovery.

4. Loans :

Loans should be verified with the help of loan agreements a acknowledgements from the loanees. Securities for secured loans should examined by the auditor and if loans are unsecured, he should enquire about the company proposes their recovery. These loans should be shown separa from the ordinary sundry debtors and be shown and classified as in the cas book debts. Similarly, the auditor should verify if any loans have been advance the directors of the firm and this should be again shown separately from other l in the Balance Sheet.

5. **Investments :**

These assets may consist of government securities, debentures and share. The auditor should inspect all securities in the form of share certificates, government promissory notes or bonds, debentures etc. and should check them with the Investment Register of any investments have been sold since the date of last Balance Sheet, he should trace the proceeds in Cash Book. Where investments are held by third parties either as security or for safe custody, the auditor should ask for certificates from them. The next step for the auditors is to vouch all receipts of interests and dividends on account of investment.

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Valuation of Investment :

Method of valuation of investments depends upon purpose for which they are held, if they are held to earn dividends and interests for the company which in turn is to be distributed to the shareholders, those should be treated as fixed assets and hence should be valued at their cost ignoring the market value. And no provision for depreciation is made on them as is done for other assets. But where investments are held temporarily with the object to sell them, these are treated as floating assets and hence should be valued at cost or market price which ever is lower at the date of Balance Sheet.

6. **Cash in Hand :**

It is always advisable to verify cash in hand by actual counting on the date of Balance Sheet. However, it is not always feasible to count them because of cash lying at branches and with agents. In this case certificates obtained as to the amount of cash in hand from the branches or agents should be examined. Some surprise check after the date of Balance Sheet is desirable to ensure accuracy of cash in hand.

7. **Cash at Bank :**

Cash at Bank is to be verified by referring to the Bank Reconciliation Statement compared with certificate as to balances at bank obtained from the bank itself. The auditor should carefully examine the bank Reconciliation Statement, He should check the receipt of deposits and withdrawals. If there is any fixed deposit, he should obtain a certificate from the bank about it.

Verification and Valuation of Liabilities

Dear Students,

In this lesson you will find how the liabilities of the company are verified by the auditor to ascertain their existence and extent and or that matter what books of accounts, documents, certificates etc. are relied on by him to discharge this part of the audit process.

Verification and Valuation of Liabilities :

Verification of liabilities by the auditor is as important as that of assets in order to ascertain correct financial position of the company. It has the same effect of inflating or deflating financial position of the company as revealed in the balance sheet, depending on over or under statement of liabilities. The auditor the has to exercise the same degree of care and caution to verify the liabilities company.

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The task of valuation of liabilities of the company is not the same as fa the auditor in the matter of valuation of assets. It is so because the personal c common sense of director and well established accounting conventio practices weigh heavily when assets are valued. Subjective considerations do into influence valuation of assets, though it is always discouraged. Besid auditor's personal judgment is often subordinated and influenced by the e opinion in respect of valuation of a particular asset where the auditor does no the requisite technical competence to value the same. In view of all these, v say that the assets side of the Balance Sheet is an expression of opinior considered as a totality. But same is not true in the case of the liability side Balance Sheet. Barring a few liabilities like contingent liability, all other liabili revealed in the Balance Sheet are based on facts not on opinions. Their valu exact not subject to influence of the opinion or judgment of the auditor or any of the company. In view of this the problem of valuation of liabilities does no Only thing that the auditor should be particular about it to see that liabiliti revealed in the Balance Sheet at their exact amounts. He should obtain a cer from a responsible officer as to the fact that (i) all liabilities are shown in the B Sheet, (ii) and they are shown at their correct amount.

Now the students are advised to follow how the various liabilities are ve

A. Share Capital

If the auditor is verifying the capital of a partnership firm, he should ex the partnership deed and Cash Book to ascertain the share of contribu individual partners and the total capital of the firm.

But, if he is auditing a company, the procedure adopted is elabora exhaustive. He should examine the Memorandum of Association, Regis Members, Cash Book, Bank Pass Book, Minutes Book. He should asserta total paid up capital, calls received in advance, and in arrear, amount on fo shares, premium or discount on issue of shares and see that these are pr dealt with in the appropriate books of accounts. He should also be careful to fi that the relevant provision of the Companies Act have been properly complie in the matter of share capital transactions.

B. Debentures

The auditor must first ascertain if the company has the sanction to debentures in referring to Memorandum of Association and Articles of Assoc He should examine books to find out if the debentures are issued at par, at pre or at a discount and whether it has been appropriately dealt with in the bo accounts. If the debentures are issued at premium the excess amount reali not to be distributed as dividends if this is not specifically permitted by the A of Association. If these are issued at a discount, these should be shown at thei value in the Balance Sheet and the amount of discount should be written off as as possible. Again, if they are issued at par and are to be redeemed at a premium, loss on such account should be charged to the Profit and Loss Account.

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Further, if the company has issued redeemable debentures, the auditor should examine the terms of redemption. If the company has made any profit on account of redemption, this should be treated as capital gains. The auditor should see that all terms of redemption have been duly complied with.

C. Trade Creditors

For verifying this item of liability, the auditor should obtain a schedule of creditors to be checked with the balances in the Purchases Ledger. The balance as shown in the schedule of creditors should tally with the balance in the Purchases Ledger. He should check the postings of the Purchases ledger and the books of original entry be vouched with purchases, credit notes, Goods Inward Book, Goods Outward Book etc. The balances of Purchases Ledger accounts should be checked with the Creditor's Statements and verified as far as possible with Cash Payments made during the subsequent period upto the date of audit. He should see that all goods received during the year have been included in the purchases. To find out if some invoices have not been entered in the books, he should compare the percentage of gross profit on turn over with what was earned in the preceding years. If he has any doubt, he should obtain statements directly from the creditors to verify them with credit balances.

D. Bills Payable

The auditor should check the Bills Payable Book with the Bills Payable Account and the bills paid should be vouched with the returned bills to ascertain the payments made for the mature bills. The balance of the Bills Payable Account should be referring to the unpaid bills shown in the Bills Payable Book. The Cash Book for the succeeding period should be closely examined to find out if any payments were made or such bills which matured on the date of Balance Sheet but were not shown in the balance Sheet. If the auditor desires, he can obtain acknowledgement from the drawers of the bills as to the payment of bills made to them.

E. Loans

Auditor should vouch loans with correspondences made with the lenders which will show the amount of loans, rate of interest and other terms and conditions of such loans. In case of bank loans and overdrafts, he should obtain certificates form the bank to verify them. If the loans are secured by way of giving mortgages, that should be clearly mentioned. Any interest due on loans, but not paid on the date of Balance Sheet should be shown as liability.

F. Outstanding Expenses

The expenses which are due but not paid are known as outstanding expenses and should be shown as liabilities in the Balance Sheet. The auditor should ascertain such outstanding expenses due on account of non-payment of rent, electricity, commission, discounts, tax, etc.

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G Contingent Liabilities

These are as a matter of fact, not liabilities in true sense of the term, b likely to turn out to be liabilities on the happening of certain event. This occurs bills have been discounted but on their maturity for payment, those are dishon by the drawers. In order to verify these liabilities, the auditor should verify the Receivable Book with bills discounted and a certificate from the bank shou obtained. He should satisfy himself that adequate provision has been mac those contingent liabilities which are apprehended to turn out to be actual liabi He should also ask for a certificate from a responsible officer of the company the fact that all known liabilities have been brought to the accounts.

Balance Sheet Audit

Generally a detailed audit starts from checking of books of primary entr ends with the Balance Sheet. The procedure of audit is quite satisfactory v applied to the audit of small and medium six concerns. But in large concerns w transactions are numerous, the final audit is not exactly helpful to reveal all tr because transactions entered in the books of primary entry may be missin presented in the synopsis form by means of summarization in the process of pos and therefore it becomes difficult to trace the direct link between a transaction i book of primary entry and its final presentation. Besides, in large companies, system of internal check coupled with internal audit is sound enough to rende exhaustive checking of original entries redundant. For these reasons, it is increasingly felt that audit should start with verification of items appearing in Balance Sheet and where auditor feels so necessary, he can look to the orig entries and check them with concerned vouchers.

The Programme for a Balance Sheet Audit

After satisfying himself in respect of adequacy and soundness of the inte check and internal audit in operation in the concern, the auditor should go for Balance sheet Audit. Balance sheet audit calls for maximum professional exper and skill and hence, this task should not be entrusted to a clerk. He should draw a detail programme and incorporate the following points for such audit. The aud should :

1. Compare each item of the Trading, Profit and Loss Account with t corresponding item of the previous year to find out if there are any mate variations and reasons thereof.
2. Try to find out if there is any material change in the rate of gross profit from t last year.
3. Try to find out if there is any great variation in the net profit from the precedi accounting period.
4. Note any extra-ordinary non-recurring transactions which have considerab affected the revenue of the period.
5. Examine the effect of profit as shown in the Balance Sheet on liquidity positio long term liabilities and fixed assets.

6. Compare the item, trade debtors with this item of previous year and if he finds any abnormal increase he should question it. Further if he finds that debtors are given long term credits he should see that adequate provision for bad and doubtful debts has been provided for.

7. Similarly examine what is due to the trade creditors in respect of purchases of the year and the period of credit taken.

8. Refer to the minute books to find out any decision having effect on capital commitments, capital issues, commission payable.

9. Note, if there is any change in the basis of valuation of current assets such as stock and work-in-progress.

10. Examine the soundness of all provisions provided for.

11. Enquire about nature of any contingent liabilities and commitments for capital expenses not provided for in the accounts.

12. Ascertain the amount involved in any contracts for forward purchases of sale.

13. Verify any other assets or liabilities not already covered.

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The student should bear in mind that the above mentioned points are in the nature of the guidelines for Balance Sheet Audit. The auditor may find some peculiarities with his client's firm and accordingly he should apply his common sense to incorporate any other points he feels appropriate and relevant.

The next step that auditor should follow is to prepare working papers. There are a set of detailed schedules for each class of assets and liabilities shown in the Balance Sheet and each schedule may be further supplemented by sub-schedules reconciling the particular asset or liability with the corresponding figure in the previous Balance Sheet so as to bring out transactions affecting the account during the period under audit.

The final step in the Balance Sheet audit is the detail checking. Before the auditor undertakes this phase of auditing, he should make a thorough study of internal check system operating in the company. If he finds that the system is full-proof, he should then resort to sample checking instead of census or detail checking. In sample checking, he should carefully pick some representative items and he should check them from the primary records to their ultimate posting in the accounting system.

QUESTIONS FOR LESSON Nos. 9, 10 and 11

LESSON No. – 9

1. What do you mean by verification and valuation ? what are the points of difference between the two ?

2. "Auditor is not a valuer" – Examine the statement in the light of auditor's duty as regards valuation of assets.

3. What are the basic principles that auditor would follow on verification of assets ?

4. What are the points the auditor should follow on verifying the following fixed assets ?

a. Land and Buildings

b. Plant and Machinery

c. Furniture and Fittings

d. Loose books and

e. Goodwill

NOTES

5. As an auditor how would you value the following assets :

a. Land Buildings

b. Patents and Copyrights

c. Motor Vehicles

LESSON No. – 10

1. What methods are followed in valuing the current assets ?
2. Discuss in detail the method of verification of stock-in-trade.
3. What methods would you follow as an auditor for valuation of stock?
4. How are the following current assets valued :

a. Book-debts,

b. Bills Receivable,

c. Investments,

d. Cash in hand,

LESSON No. – 11

1. "The task of valuation of liabilities is not the same as the valuation of ass
Comment.
2. As an auditor how would audit the following items of the liabilities :

a. Share Capital,

b. Trade Creditors,

c. Bills Payable,

d. Contingent Liabilities ?

3. What is a 'Balance Audit' ? How does it differ from traditional audit ?
4. Draw up a programme for the Balance Sheet audit of a large manufactu
company.
5. What are successive steps would you take in the course of Balance S
Audit ?
6. What caution would you exercise while you audit the following items :

i. Loans,

ii. Outstanding liabilities,

iii. Bills matured for payment on the date of Balance Sheet, but not pa

RESPONSE SHEET

Answer the following questions : (Any five)

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1. What is meant by Bought ledger ? How would you vouch Bought ledger and Sales ledger.
2. Clearly define the following terms.
   a. Capital Reserve
   b. Sinking Fund
   c. Depreciation Fund,
   d. Reserve Fund
3. Write the difference between reserve and reserve fund. Suggest when reserve fund will be invested in outside securities.
4. What are the principles followed in the verification of assets ?
5. What is the difference between verification and valuation ?
6. How the following assets are valued ?
   a. Land and Building
   b. Motor Vehicles
   c. Patents and Copyrights
7. How the following current assets are valued ?
   a. Stock
   b. Book-debts
   c. Bills Receivable
   d. Short term Investments
   e. Cash Balance
8. What is a 'Balance Sheet Audit' ? How does it differ from traditional audit ?
9. How the following liabilities are audited ?
   a. Share Capital
   b. Contingent Liabilities
   c. Bills Payable
   d. Trade Creditors

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UNIT – III : AUDIT OF A LIMITED COMPANY

NOTES

STRUCTURE

3.0 Objectives
3.1 Introduction
3.2 Appointment of a company auditor
3.3 Rights and Powers of Company Auditor
3.4 Duties of the company auditors
3.5 Liabilities of a company auditor
3.6 Divisible profits and dividends
3.6.1 Divisible profits
3.6.2 Factors affecting Payment of Dividend
3.7 Auditors Report
3.7.1 Auditing Procedure of Banking Companies
3.7.2 Auditing procedures of Educational Institutions
3.7.3 Auditing Procedures of Insurance Companies

3.0 OBJECTIVES

After going through this lesion you will be able to

- Know how the company appoints auditor
- Define the liabilities of company auditor
- Elaborate the Auditor's Report

3.1 INTRODUCTION

According to the companies Act, 1956, the accounts of the joi companies are required to be compulsorily audited. It is therefore significance of studying the principles and procedures of auditing as appli a joint stock company. The provisions regarding the company auditors are co in section 224 to 233, which lay down the qualifications and disqualifica company auditors, procedures regarding their appointments, removal, rights powers, remuneration and reappointment.

3.2 APPOINTMENT OF A COMPANY AUDITOR :

The companies Act 1956, made it obligatory for a company form of b whether public or private to appoint auditor or auditors for auditing its b accounts. Section 224 of the companies Act deals with the appointment of of a company which is discussed as under:

(A) Appointment of First Auditor :

According to section 224(5) of the companies Act, the first audito company shall be appointed by the Board of Directors within one month of t of registration of the company. Such auditors shall hold office until the end of the first annual general meeting. They are appointed for the purpose of audit of the statutory report and for the inclusion of their name in the prospectus.

NOTES

If the first auditors are not appointed by the Board of directors, they may be appointed by the company in a general meeting. They shall hold office until the conclusion of the first annual general meeting. There is no legal requirement regarding the intimation of appointment to the first auditors by the company. The first auditor is also not required to inform the Registrar of companies about his acceptance or refusal of such an appointment.

(B) Re-appointment of Retiring Auditor :

According to section 224(2), sub-section 1-B and section 224-A,a retiring auditor by what so ever authority appointed shall be re-appointed in the annual general meeting except in the following cases :

1. he is not qualified for re-appointment.
2. he has given to the company notice in writing of his unwillingness to be reappointed.
3. a resolution has been passed at that meeting : (i)to appoint somebody other than him, or (ii)to provide expressly that he shall not be reappointed.
4. reappointment of the retiring auditor shall also not be made if he is already holding auditorship in more than the specified number of companies.

(C) Appointment by central government :

According to the provisions of section 224(3) where an auditor is not appointed or re-appointed at the annual general meeting, the company must notify the fact to the central government within seven days thereafter. There upon the central government will appoint a person to fill the vacancy. If a company fails to intimate this fact within seven days, the company and every officer of the company who is in default, shall be punishable with fine which may extend to five hundred rupees. Where the appointment by the central government becomes necessary, an application has to be made to the regional director.

(D) Appointment by special resolution

Section 224-A of the Act states that in the case of a company in which not less than 25% of the subscribed share capital is held, whether singly on in any combination by:

(i) a public financial institution or a government company or central government or any state government, or

(ii) any financial or other institution established by any provincial or state Act in which the state government holds not less than 51% of the subscribed share capital (includes preference share capital also) or

(iii) a nationalized bank or an insurance company carrying on general insurance business,

NOTES

The appointment or re-appointment of an auditor(s) at each annual
meeting shall be made by a special resolution.

According to section 224(3), if a company fails to pass a special reso
its annual general meeting for the appointment of an auditors, appointment by
government becomes applicable.

(E) Casual vacancy : [Section 224(6)]

(i) If a casual vacancy arises on account of death, insanity or insolvenc
be filled up by the Board of directors. The remaining auditors or audito
may act during the continuance of a casual vacancy.

(ii) An auditor appointed to fill up the casual vacancy shall hold office
conclusion of the next annual general meeting of the company.

It should be noted that casual vacancy does not arise in the office of the
on the expiry of one year of their appointment, if the annual general meetir
held in time. The appointment of auditor(s) under such a case by the board of
stands invalid.

(F) Appointment of a new Auditors in place of retiring auditor :

Section 225 lays down the detailed procedure for the appointment c
auditor in place of the retiring auditor. A special notice of 14 days before the
the meting is required for a resolution at an annual general meeting, appoi
auditor a person other than a retiring auditor sub-section (2) of section 225 p
that on receipt of the notice, the company shall send a copy there of to the
auditor froth with.

(G) Appointment of Auditor of a government company :

A government company has been defined in section 617 of the Act
company in which not less than 51% of the paid-up share capital is hel
central government or by any state government or governments or partly by th
government and partly by one or more state governments and includes a c
which is a subsidiary of a government company as thus defined.

The appointment of an auditor is governed by the provisions of sectio
the Act. According to this section the auditor of a government company
appointed or reappointed by the central government on the advice of the cor
and auditor general of India. However, the appointment will be subject to the
as per section – 224(IB).

3.3 RIGHTS AND POWERS OF COMPANY AUDITOR :

The companies Act has given certain rights and powers to an auditor to
him to discharge his duties effectively. These rights are statutory ones an
with the duties cast upon him. The various rights and powers of an auc
mentioned below :

(A) Right of Access to Books and Vouchers : [sec-224(1)

Every auditor of a company has a right of free and complete acce
times to the books, accounts (all financial, commercial, cost records main

under section 209-(1)(d) and memoranda books) and vouchers of the company whether kept at the head office or elsewhere.

NOTES

(B) Right to obtain Information and Explanations : [section-221]

The auditor has the right to ask any information and explanation from the directors and officers of the company which he may think necessary for the performance of his duties as an auditor. According to section 221, it is obligatory for the officers of the company to furnish without delay the relevant information to the auditor.

(C) Right to Receive notice and Attend General Meeting. [sec-231]

The auditor has a right to receive all notices and communications pertaining to all general meetings of the company whether the accounts are discussed or not in that meeting. He is entitled to attend any general meeting and to be heard on any part of the business which concerns him as an auditor.

(D) Right to visit branches :

The company auditor has a right to visit the branch office if he considers necessary for the performance of his duties as auditor. He has also right access at all times to the books of accounts and vouchers of the company maintained at the branch office. However in case of a banking company having a branch outside India, the auditor has no right to visit foreign branches of a banking company.

(E) Right to Report to members. [sec-227(2)

The auditor has a right to make a report to the members on the account examined by him. He has to state whether the said accounts give the information required by the companies Act and whether the financial statements give a true and fair picture of the state of affairs of the business of the company and of the results of its operation.

(F) Right to correct wrong statement :

The company has a right to correct any wrong statements which has been made by the directors in connection with the accounts of the company in the general meeting.

(G) Right to take expert's advice :

The company auditor has the right to seek the opinion of the experts in the performance of his work.

(H) Right to receive remuneration

The company auditor has a right to receive his remuneration provided he has completed the work assigned to him.

(I) Right to be indemnified :

The auditor has a right to be indemnified out of the assets of the company for all the legitimate expenses incurred by him in defending any civil and criminal suit filed against him in court of law provided he has own the case.

NOTES

(J) Right to sign the Audit report :

An auditor appointed by the company may sign the auditor's rep authenticate any other document required under the Act to be signed.

3.4 DUTIES OF THE COMPANY AUDITORS :

The duties of a company auditor may be of two types i.e. (A) Statutory and (B) Others duties

(A) Statutory duties

The followings are the statutory duties of a company auditory.

1. Duties to make report :

The primary duty of the auditor is to prepare and give a report to the mer of the company on the accounts examined by him, on every balance sheet, profit and loss account and on every other document declared by this Act to b of or annexed to the balance sheet and profit and loss account which are laid b the company in its general meeting during his tenure of office.

2. Duties to report the various facts to members :

The audit report, besides other things necessary in any particular case contain the following :

(i) Whether, in his opinion and to the best of his information and accord explanations given to him, the accounts give the information required Act and in the manner so required.

(ii) Whether the balance sheet gives a 'true and fair view' of the company's as at the end of the financial year and the profit and loss account giv authentic picture of the profit and loss for its financial year.

(iii) Whether he has obtained all the information and explanation required b for the purposes of his audit.

(iv) Where the company's balance sheet and profit and loss account dealt w the report are in agreement with the books of accounts and returns.

(v) Whether or not the balance sheet and profit and loss account have been up according to the requirements of the company Act.

3. Duty to enquire :

Under the section 227(1-A) of the companies Act, an auditor has to en into the following six matters ;

(i) Whether loans and advances made by the company on the basis of se have been properly secured and whether the terms on which they have made are not prejudicial to the interests of the company or its members

(ii) Whether transactions of the company which are represented merely by entries are not prejudicial to the interest of the company.

(iii) Where the company is not an investment company or a banking compan auditor has to enquire whether it has sold any shares debentures or securities at a price which is less than the price at which these were purchased by it.

(iv) Whether loans and advances made by the company have been shown as deposits.

(v) Whether personal expenses have been charged to revenue account.

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

NOTES

4. Duty to certify statement in prospectus :

According to part-II and schedule-II of section 56(1) of the companies Act, the auditor has the duty to certify statement in prospectus with regard to profits or losses, assets and liabilities of the company and its subsidiaries.

5. Duties to certify statutory report :

The auditor has to certify the statutory report as correct according to section 165(4) of the companies Act. After the statutory report has been certified as correct by not less than two directors of the company one of whom shall be a managing director, the auditor must certify it as correct to the extent it relates to :

(a) shares allotted by the company,

(b) cash received in respect of such shares and

(c) receipts and payment of the company.

6. Duty to assist investigation

Where an inspector is appointed under section 235 to 237 to investigate in to the affairs of the company, it is the duty of an auditor to render all possible assistance to the inspectors as he is capable of rendering.

(B) Other duties :

1. Acquainted with provisions of law : An auditor must make himself fully acquainted with his duties under the articles of association and the companies Act.
2. Re-verification of assets etc.: It is the duty of an auditor to verify the assets himself. He cannot rely on statements of the management with regard to matters which can be directly verified by him from books, accounts and vouchers.
3. Report suspicious matters : Where there are materials before the auditor which arouse his suspicion it is the duty of an auditor to point out these to the shareholders.
4. Reasonable care and caution : it is the duty of an auditor to perform his task with reasonable skill, care and caution which a reasonably competent, careful and cautious auditor should use. What is reasonable skills, care and caution depend on the particular circumstance of each case.

5. Avoid foul means : An auditor should not adopt foul means shareholders to get himself appointed as an auditor and maintain h two places to defraud other.

NOTES

6. Certificate of practices : it is the duty of an auditor not to practise as unless he is a member of the institute of chartered accountant of holds a certificate of practice granted by the council of the institute

7. Abide professional ethics : The professional career of an auditor is his technical competence, soundness of judgement, honesty, ab only the written rules of the Act but also those unwritten rules which the code of professional ethics and conduct.

3.5 LIABILITIES OF A COMPANY AUDITOR :

An auditor to audit the accounts of a public limited company is a under the provisions of the Indian companies Act. His duties and liabilitie laid down in this Act. The Act also prescribed certain professional knowl skill which an auditor must possess. Ordinarily, an auditor would be held any loss which his client may have suffered due to the absence of the req or his failure to exercise it can give rise to an action for damage for pro negligence. The liabilities of a company auditor may be discussed as fol

Liability of a company auditor

A. Civil liability
   (1) Liability for negligence
   (2) Liability for misfeasance

B. Criminal Liability

(A) Civil Liability :

Liability of an auditor to pay damages is known as Civil Liability. Thi arises out of civil wrong which may have regulated due to negligence or b trust and duty. In such a case, action for damages is brought against the au civil court. Civil liability may be of two types. They are –

1. Liability for negligence :

In this case the liability of an auditor arises where it is proved that h has suffered a loss due to his professional negligence. As such he is liable good that loss on an action being taken against him by the party. However, ar is not liable when there is loss without his being negligent or if it is proved auditor was negligent in the performance of his duty he cannot be held li damages, if the company has not suffered any loss due to his negligence.

2. Liability for misfeasance :

The term 'misfeasance' means breach of trust or breach of duty impo law. If an auditor does something wrongfully in the performance of his duties re in a financial loss to the company, he is guilty of misfeasance. The directo other important officials of a company may also be held for misfeasance.

NOTES

(B) Criminal Liability

Criminal liabilities are those which arise because of offences against the statutory provisions. These may emerge due to criminal neglect, actual fraud or conspiracy under the companies Act. An auditor of a company may be found guilty of criminal offences if he willfully makes a false statement in any report, return, certificate or balance sheet etc. The following are the cases where an auditor can be held criminally liable.

1. Misstatements in prospectus :

A company auditor is criminally liable for any un true statement in the prospectus. He shall be punishable with imprisonment for a term which may extend to the years or with fine which may extend to rs.5000/- or with both.

2. Failure to return property books or papers :

When a company is wound up by the court, the auditor is supposed to be present and submit the return of property books or papers. If he fails to do so, he will be liable.

3. Penalty for falsification of books :

An auditor may be criminally held liable for falsification of books if in order to defraud any person, he destroys, mutilates, alters, falsifies or secrets, the books of account or documents belonging to the company.

4. Liability under the Indian penal code :

An auditor is also liable under the Indian penal code for frauds and for furnishing false information etc. According to section – 177 of the Indian penal code the auditor will be liable for simple imprisonment upto six months and/ or fine upto Rs.1000/- for furnishing false information.

5. Liability under Income tax Act 1961 :

Some times an auditor may act as a professional accountant for his client in the matter of income tax and if he presents any false statement of chargeable incomes, he will be liable under the income tax act.

(C) Liability to third parties :

The third parties can bring a suit against the auditor only for default and not for negligence. The auditor shall be held liable for damage to third parties only when his report comes out to be of such a nature that it amounts to fraud. Sometimes gross negligence on the part of an auditor is amounting to fraud and for that mater he will also be held liable to third parties.

3.6 DIVISIBLE PROFITS AND DIVIDENDS :

3.6.1 Divisible Profits :

Meaning :

All the profits of a company are not divisible. Only those profits which can be legally distributed in the form of dividend to the shareholders of the company are called as "divisible profits".

NOTES

There is no definition of the term divisible profit in the companies Act. H section 205 of the companies Act, which deals with the question of div provides that no dividend may be declared or paid except out of the profi company arrived at after providing for depreciation in the manner prescribe behalf under the Act. The dividend may also be paid out of the funds prov this purpose by the central or state government in pursuance of a guarante by such governments.

Determinants of divisible profits

From the above discussion, it now stands clear that there is no cl definition of the term divisible profit. Therefore, determination of divisible pr company is governed by the following factors :

A. Provisions of companies Act 1956

B. Memorandum and articles of association

C. Accounting principles and

D. Legal decisions.

A. Provisions of companies Act, 1956.

The companies Act, 1956 does not lay down any definition to the term d profits. Till 1956 there was also no provision defining the divisible profit e "Regulation for management of a company limited by Shares" as contained in 'A' (Clause 85 to94).

Important provisions of the Companies Act, 1956 regarding divisible are as follows :

1. Depreciation :

According to section 205(1) Dividend can be declared or paid by a com for any financial year only :

(a) Out of profits of the company for that year arrived at after providin depreciation in accordance with provisions as per Section 205(2), or

(b) Out of profits for any previous year or years after providing depreciati per Section 205(1) or

(c) Out of the aggregate of its profits mentioned in (a) and (b), or

(d) Money provided by the central or the State Government for the paym dividends in pursuance of a guarantee thereof.

2. Transfer to Reserve :

Under Section 205(2A), no dividend shall be declared or paid by a com for any financial year out of the profits for that year arrived at after providin depreciation in accordance with the provisions, except after transfer to the res of the company of such percentage of profits for that year not exceeding 10% may be prescribed.

B. Memorandum and Articles of Association :

The directors recommend the distribution of profits as dividends after making necessary reserves and provisions as prescribed in memorandum and Articles of Association. Provisions in memorandum and Articles of Association may differ from company to company depending on their nature of business, though arrangements are more or less similar as required by law.

C. Accounting Principles :

Divisible profits are the surplus of income over expenditure of a given period. The determination of surplus to a large extent is determined by the Principles of Accounting. Accountants differ in their approach while determining the profits of the business. Some of such difference which has a bearing on the divisible profits are–

(i) Methods of charging depreciation.

(ii) Methods of valuation of inventory.

(iii) Appropriation of deferred revenue expenditure.

(iv) Charging capital expenditure for revenue.

D. Legal Decisions :

The legal decisions have laid down certain principles for arriving at divisible profits by a joint stock company.

3.6.2 Factors Affecting Payment of Dividend :

1. The most important thing to which directors must pay their attention is the correct ascertainment of divisible profits. They must decide if they are recommending dividend out of revenue profits or capital profits.

2. If the dividend is recommended out of capital profits, it must be ensured that (a) such a distribution is authorized by the Articles of Association and that (b) the profits have actually been realized in cash and (c) that they remain as a surplus after fair revaluation of all the assets of the company. Dividend out of capital profits can not be declared without making good all the capital losses.

3. If the dividend is recommended out of revenue profits, it must be ascertained that a provision has already been made for depreciation both on fixed and floating assets and past losses in accordance with the requirements of Sec 205 of the Companies Act.

4. Arrears of depreciation as well as earlier losses to the extent they represent depreciation in respect of the financial years after 28th December, 1960, must be made good out of profits available for distribution, before any dividend can be paid.

5. All appropriations legally required must be made out of profits before they are distributed. In the case of bank, 20% of the net profits must be creditd to General Reserve before any dividend is distributed. In the case of other companies, the following provision of the statutory reserve must be made before declaring dividend :

2½ of the net profits if the dividend proposed exceeds 10% but not 12

5%	12½%	15%
7½%	15%	20%
10%	20%	

NOTES

6. If the company has raised a part of its capital by the issue of debentur the condition that a part of profits annually would be credited to the Debe Redemption Fund, it would be necessary for the directors to transfe specified amount of the profits to such a fund.

7. It should be considered that the distribution of profits will not have any adv effect on the liquid, resources or the working capital of the company. More declaration of dividend will in no way check the expansion of the activiti the company.

8. Directors must ensure that the company has or will have sufficient resources to pay off the dividends within 42 days of their declaration ir general meeting. If a company fails to pay dividend within 42 days c declaration, it shall deposit the unpaid amount of dividend in a special un dividend account to be opened with a Scheduled Bank. Money remair unclaimed for a period of three years from the date of transfer to the unp Dividend account shall be transferred by the company to the General Rese Account of the Central Government in the Reserve Bank of India.

9. All arrears of dividend and also the current dividend at the rates fixed be p first to the holders of Cumulative Preference Shares before any dividen recommended to be paid on Equity Shares.

10. To avoid wide fluctuations in the prices of shares and to discourage unheal speculation, an effort should be made to maintain a steady rate of divide over several years. Past tradition of the company with regard to the declarati of dividend and the effect of dividend recommended for the current year the shareholders must be taken into account.

Thus, to conclude, dividend should not be recommended contrary to t provisions of the Companies Act or the Articles of Association, against the be interests of the company and the recommendations must be fair to all the partie interested therein.

3.7 AUDITOR'S REPORT :

Means : The audit report is fundamental to any audit. It is the end product c every audit. It is the medium through which an auditor expresses his opinion on th financial statement.

A report is a document which contains the opinion of the auditor on the financia statements or its components or items examined.

Auditors Report can be of two types.

(i) Unqualified Report

(ii) Qualified Report

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(i) **Unqualified Report :**

An auditor gives his unqualified opinion in this form when he is satisfied that the accounts and related documents of the company give a true and fair picture of its state of affairs and result of operations. In his such disqualified opinion the auditor does not make any qualifications, modifications or reservations and his report is free from 'ifs and buts'. Such a report is also called a clear or clean report. It shows that the Balance Sheet and Profit and loss A/c of the company are in conformity with the accounting Principles and legal provisions. If the auditor feels necessary he can mention reasons for his giving such findings.

Sec. 227(2) of the Companies Act requires from an auditor to answer certain questions in his report to the members in respect of the Balance Sheet and Profit and Loss Account and annexure thereto. If the auditor finds affirmative or positive answers without any qualification or modification the report of the auditor stands as unqualified report.

An example of an unqualified report is given hereunder :

To

The Shareholders,

(.. Name of the Company ....)

We have audited the attached Balance Sheet of the ...(name of the Company), as at the 30th day of June (year) and also the annexed Profit and Loss Account of the company for the year ended on that date together with the schedules referred to therein and the books and accounts as kept in English at the Company's Head office and report that:

1. We have obtained all the informations and explanations, which to the best of our knowledge and belief were necessary for the purpose of our audit.
2. In our opinion proper books of account as required by law have been kept by the company, so far as appears from our examination of the books and proper returns adequate for the purpose of our audit have been received from the branches not visited by us and we have dealt with them in framing of this report.
3. The Balance Sheet and Profit and Loss Account dealt with by this report are in agreement with the books of account and returns.
4. In our opinion and to the best of our information and according to the explanations given to us, the Accounts read with the notes thereon, give the information required by the Companies Act, 1956 in the manner so required and give a true and fair view of the state of company's affairs as at 30th June (year) and the Profit ad Loss Account gives a true and fair view of the profit for the year ended on that date.
5. That the report on the accounts of the Branch offices audited under Sec. 228 by other auditors have been received by us and that we have properly dealt with that in preparing our report.

Date.................

Sig..............................

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(ii) **Qualified Report :**

Auditors' report which brings to the notice of the members that there are certa things to be modified or improved and the accounting system is not satisfactory give true and fair view of the state of affairs of the company and in such a report t auditor makes certain reservations with detailed reasons and also mak modifications and qualification giving qualified opinion, the report is called qualifi report.

It is necessary for the auditor that he should express all the effects on t financial status of the company for his reservations. He should not give doub expressions in his report. The report should be expressive on each and every asp of the financial status of the company. He should also explain as to why he is una to give his unqualified opinion.

A qualified report is given by the auditor when the Balance Sheet and Pr and Loss Account do not show the true and fair view of the state of affairs a results of operations of the company or the accounts are not in conformity with generally accepted accounting principles or they do not fulfill legal requirement the company has not maintained proper records of its affairs or the explanati made,to the auditor are not acceptable to him. For giving such opinion the aud should carefully see each and every aspect of his reservations. This type of repo always an outcome when the questions required to be answered under Sec.22 of the Companies Act are in negative or are not replied due to certain reasons. qualified opinions expressed by some reservation words e.g. "Subject to" or "ex that".

An example of the 'Qualified Report'.

Auditors' report to the members of .... (name of the company...)

We have audited the Balance Sheet of M/s (.. name of the company...) 31st march...(year).... and the Profit and Loss account for the financial year e on that date as annexed thereto.

A reference in regard to imposition of workmen compensation amounti Rs.2.5 lakhs in respect of accidental death of two workmen of the company is u appeal by the company before the High Court.

Subject to any adjustments to the Balance Sheet and Profit and Loss Ac which may result from final determination of the company's liability in that rega our opinion, the financial statements give a true and fair view of the company's of affairs as at 31st March ...(year) and of its profit for the year ended on that

3.7.1 Auditing Procedure of Banking Companies

Banking companies are required to satisfy the requirements of bo Companies Act as well as the Banking Regulation Act. Some of the imp provisions of the Banking Companies Act which deserve careful attention auditor may be summarized as follows :

1. Capital (a) A banking company having all its places of business in one only other than Bombay or Calcutta shall be required to have a paid up

and reserve of an aggregate value of rupees one lakh in respect of its principal place of business plus ten thousand rupees in respect of each of its other places of business situated in the same district in which it has its principal place of business. It shall be required to have an additional capital of twenty-five thousand rupees in respect of each place of business elsewhere in the State otherwise than in the same district. Maximum amount of paid up capital and free reserves required in such a case should not exceed rupees five lakhs. A banking company having only one place of business shall not, however, be required to have paid up capital and reserves exceeding fifty thousand rupees.

A banking company having place of business in more than one State is required to have paid up capital and reserves of five lakhs rupees and if any of its place of business is situated in Bombay or Calcutta, it shall be required to have a capital of ten lakhs of rupees.

A banking company having all its places of business in one State, one or more of which are in Bombay or Calcutta, shall be required to have a paid up capital and reserves aggregating to five lakh rupees plus twenty-five thousand rupees in respect of each place of business outside Bombay or Calcutta. However, such banking company shall not be required to have a paid up capital and reserves of more than rupees ten lakhs.

A banking company incorporated outside India is required to have a paid up capial of not less than rupees fifteen lakhs and if it has a place of business in Bombay, Calcutta or both twenty lakhs of rupees. Such a banking company shall be required to deposit this amount with the Reserve Bank in cash or unencumbered securities.

(b) The paid up capital of a bank should not be less than half of the issued or subscribed capital and the subscribed capital should not be less than half of the authorized capital. A new banking company incorporated after 15 January, 1957, can not raise its capital by issuing preference shares. The capital of a banking company shall consist of only Equity Shares. A member of a banking company can not exercise voting rights on a poll in excess of 5% of the total voting rights of all the shareholders of the banking company.

A banking company is not allowed to pay more than 2½% of the paid up value of the shares issued by it by way of commission, brokerage, discount etc. for the issue of such shares.

A banking company can not create any charge upon its uncalled capital.

2. Management. A banking company can not be managed by managing agents. The managing director of a banking company must not be the managing director of any other company. He should not be engaged in any other business or vocation. Appointment of managing director for a period of more than five years at a time shall not be valid. Chief executives or the managing director of a bank can not be appointed except with the prior approval of the Reserve Bank. A banking company cannot have any person as a director, who is a director of any other banking company or who is a director of other companies which among themselves are entitled to exercise voting rights in excess of 20% of the total voting rights of all the shareholders of the banking company.

Reserve Bank can under certain conditions remove or suspend any officer of a banking company for a period upto five years.

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3. Restrictions on Dividend. A banking company cannot pay any divid the intangible or fictitious assets or capital expenses have been wri of its profits. Actual depreciation in the value of investments or bad not be written off out of profits if adequate provision has been m satisfaction of the auditor of the banking company.

4. Cash Reserve. Every banking company, other than a scheduled b maintain a cash reserve in hand or with the Reserve Bank or Stat India a sum equal to at least 2% of its time liabilities and 5% of its liabilities in India. 'Liabilities' for this purpose will not include paid u reserves, profits or advances from Reserve Bank or State Bank Banking companies are required to file with the Reserve Bank detai time and demand liabilities and also statement of cash reserve held on each Friday of the week.

5. Reserve Fund. Every banking company is required to transfer 20% profits every year to Reserve Fund before declaring a dividend Intim the circumstances under which any sum is appropriated from the R Fund shall be sent to the Reserve Bank within 21 days of such appropr

6. Restrictions on Loans and Advances. A banking company is not allo make any loans or advances on the security of its own shares or to gr unsecured loan to any of its director or to firms in which any of its dire interested as partner or managing director or to any individuals or firms any of its directors is a surety. Banking companies are required to ob the policy as framed by the Reserve Bank in connection with the mak advances.

7. Floating Charge. A floating charge on the assets of a banking compan not be created without the certificate of the Reserve Bank to the effect would not be detrimental to the interests of the depositors.

3.7.2 Auditing Procedures of Educational Institutions

1. Auditor will examine the Charter, Trust Deed, Rules and Regulations, Co the university if affiliated to it, Act of the University if it is a constituent pa the university. In order to obtain information on various decisions of Managing Committee, auditor will go through the Minutes, Book. He will ascertain the terms of endowment and will accordingly vouch the income security thereof. He will see that the income is utilized in the fulfillment of th objects for which the endowment has been made. He shall also ascertain mode of the management of the institution and the financial powers of management.

2. Auditor will enquire into the system of internal check in operation and will ma a note of its weaknesses to which he will pay his greatest attention. He w also ascertain if any standard form is prescribed for the presentation accounts.

3. Auditor will carry out a thorough vouching of the Cash Book. He will go through the prospectus of the Institution and the students enrolment register. He will check the amount of fees received with the number of students on the rolls and the rate of their fees. He will see that all revenues from fees have been duly accounted for and that all those fees which are considered to be irrecoverable have been written off. Auditor shall ascertain that all concessions in fees hav been duly authorized. He will see that all extra receipts such as examinations, games, library fees etc. are properly accounted for. Cash receipts can be vouched with the counterfoils of the receipts issued. Concessions in fees will also be checked by the auditors. He will see that they are properly authorized. Auditor will see that writing off of irrecoverable fees is duly authorized by the managing committee. Weaknesses in the system of recording of receipts should be brought to the notice of the trustees or the managing committee.

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4. Auditor shall verify the amount of cash in hand by actual counting and balance at bank from a certificate obtained from the bank. He shall compare Cash Book entries with the Pass Book entries and reconcile the difference in the balances disclosed by the two books.

5. Auditor will vouch very thoroughly the amount of donations or grants received by the institution. Donations may be verified from the respective announcements made by the Head of the institution on the annual day of the institution. They are also mentioned in the annual report of the institution.

6. In case of endowments, auditor will ascertain the terms of the endowment and will vouch the income and verify the securities relating to these endowments. He shall also ascertain that the income so realized is utilized by the institution in the fulfillment of those objects for which the endowments were made.

7. Auditor will verify landed property and investment from the deeds and certificates relating to them.

8. Auditor will check payments from their respective vouchers. He will obtain satisfactory explanation for unusual and extraordinary expenses. He will see that the capital expenses have been duly authorized by the Managing Committee.

9. Auditor will obtain certified inventories of furniture, stock of stationery, equipment etc., from the administrator and will verify their accuracy by test checking.

10. Auditor will vouch the revenue expenses and verify the assets and liabilities of the college in the usual manner. He will see that fees received in advance have duly been carried forward and that the outstanding fees and interest accrued have been taken into account. He will also see that all outstanding assets and liabilities have been accounted for and shown in the Balance Sheet.

11. Auditor will enquire into the system of purchase of provisions for the hostellers. He shall vouch the payments from copies of bills and receipts issued to the inmates of the hostel.

12. He will carry out thorough vouching of the repayment of library or labora securities and ensure that all outstanding have been deducted there f before refunds are granted.

13. Auditor will carry out proper verification of all funds and see that there ar unauthorized inter fund transfers. He will also verify the provident fund o employees of the institution.

NOTES

3.7.3 Auditing Procedures of Insurance Companies

Accounts and records of insurance companies are maintained in accorda with the provisions of the Insurance act, 1938. In general, companies are requ to adopt the calendar year as their financial year. Certain duties have also b imposed on the auditors by the Act. It become very essential that the auditor m perform these duties. He must see that the company has not committed any bre of the provisions of law and the accounts disclose all the information required law. Besides this, the auditor will pay special attention to the following points :

1. Auditor will examine the details, efficiency and reliability of the system of inte check in operation in the business. Because of the large number of transacti of the insurance companies. It may not be possible for an auditor to carry detailed checking. A sound system of internal check will reduce his work t very great extent.

2. Next the auditor will proceed to check up the amount of premiums receiv He will examine the policy registers and compare the receipt counterfoils w the premium cash books to vouch that all premium received have been credi in the account books. Auditor will see that in the total premium incon necessary adjustments are made for premiums received in advan outstanding or paid for reinsurance etc or refunds. Auditor will see that rebat which are prohibited by the Insurance Act have not been camouflaged refunds of premium.

3. Auditor will vouch receipts on account of interest dividends and rents. He w see that accrued income from these sources is also taken into account. Audi will obtain a statement of the return and the date when it fails due.

4. Auditor will vouch the amount of claims paid and outstanding from the ca Book, Claims Register, Director's Minutes, survey reports, cancelled policie receipts, correspondence and other evidence available. Auditor will see th the portion of the claims covered under reinsurances is not included in th item. Auditor will ascertain that the item includes all claims intimated, admitt and paid. Expenses incurred in settling claims should be debited to clai account and not charged to some other head. Auditor will also vouch the amou of surrenders in a similar manner, from the policies endorsed in favour of th company and the receipts obtained from the insured for the payment surrender money.

Auditor will see that all outstanding liabilities under reinsurance claims hav been provided for.

5. Auditor will vouch the amount of commission or allowances paid to the agents or canvassers with the terms of their appointment letters, relevant commission vouchers and the receipts given by the agents. The code of conduct requires that commissions should be paid by bank cheques unless the amounts are small. He will see that the amount does not exceed the limits set by the Insurance Act. he will ascertain that outstanding remuneration, has duly been provided for out of the current revenues.

SELF TEST

1. What special points will receive your attention, while auditing the accounts of a banking company?
2. Write short note on special feature of audit of an educational institution.
3. What are the rights and duties of an auditor of a limited company?
4. How are the auditors appointed in a public limited company?
5. What are the liabilities of an auditor under the companies Act, 1956.
6. "The auditors should keep various considerations in mind regarding calculation of divisible profits" Justify the statement.

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UNIT – IV : INESTIGATION

NOTES

STRUCTURE

4.0 Meaning, features and Objectives
4.1 Investigation when fraud is suspected
4.2 Investigation when a running business is proposed

4.0 OBJECTIVES

After going through this lesion you will be able to

- Understand the investigation and
- When it is proposed

Meaning of Investigation

Investigation means an inquiry into facts behind the books of accoun technical financial and economic position of the business for a specific purpo

Features of Investigation

Main features of investigation are :

(i) Investigation is always taken for a specific purpose.

(ii) Both intensive as well as exhaustive examination of the activity in underta

(iii) Investigation is not statutory. It is voluntary and contractual in nature.

(iv) Investigation report is to be submitted to the client.

Objects of Investigation

The object of investigation would differ with the purpose for which it us be under taken. Following are the usual circumstances which most frequently cal various types of investigation.

(1) Investigation when fraud is suspected.

(2) Investigation when a running business is to be purchased.

(3) Investigation on behalf of a bank or any lender to grant a loan.

(4) Investigation under the companies Act.

The first two are only discussed here

4.1 INVESTIGATION WHEN FRAUD IS SUSPECTED

The duties of an investigator in this connection will mainly depend upon nature of the fraud and the systems of accounting and internal check in force in business.

Investigator at the outset will try to know from his client, the reasons suspicion, the nature of fraud suspected the extent of loss and the names of suspected persons. He will obtain from his client written instructions as to his dut and scope of work and a statement as to the records and documents which will available to him for examination.

Frauds can easily be detected ifs one has the knowledge of the different forms which they may take. Frauds may be committed in different and various forms. Fraud is usually committed in the following ways :

NOTES

1. Misappropriation of cash
2. Misappriation of Goods
3. Manipulation of Accounts

1. Misappropriation of cash :

This type of fraud is generally committed by the cashier who has access to the books of accounts. It would be an impossible task to list various methods of misappropriation, as they are limitless. However, cash may be misappropriated usually in the following ways :

(a) Pilfering cash from cash box, which will result in shortage of cash balance.
(b) Omitting to record the receipt of cash-in whole or in part.
(c) Recording fictitious payments.
(d) By teeming and lading or lapping
(e) Manipulation of petty cash transactions and wage payment
(f) Holding back collections remitted by traveling salesmen.
(g) Writing off a good debt as bad and irrecoverable to cover up the cash misappropriated.
(h) Adjusting a cash sales as credit sale and raising a debit in the account of the customer.
(i) Casual receipt of cash i.e., recoveries from sale of scrap.
(j) Withdrawing unclaimed credit balances of customers account
(k) Personal expenses may be charged to business by falsifying details.

Procedure for Investigation of Misappropriation of cash

The following procedures are followed by the investigator for investigation of misappropriation of cash :

(a) The professional accountant must acquaint himself duly with the nature of fraud.
(b) He should make enquiries and test check the system of internal check with regard to cash receipts and payments.
(c) He should also know the respective duties of the employees in order to find out what opportunities they had for misappropriation.
(d) The missing cash memos or any alterations on the cash memos must be closely scrutinized and proper explanation must be asked for.
(e) He should compare the counterfoils of pay-in-slips with the entries in the cash book. If there is any difference between the two, a proper explanation must be asked for.

(f) All cash payments must be vouched and duplicates of all missing vo
should be asked for.

(g) The petty cash must also be vouched. It is usually seen that pett
transactions provide many possibilities of frauds.

NOTES

(h) Any entry of unusual discount or allowance must be enquired in
misappropriation can be done by showing more discount than actually al

(i) He should obtain the names of the persons responsible for signin
endorsing the cheques.

(j) Investigator should make full note of all the irregularities discovered an
probe into these matters.

2. Misappropriation of Goods :

Goods which are readily convertible into cash are usually misappropr
Misappropriation of goods is possible only by the collusion of several persons
circumstances where either the inventory system is very poor or goods are of
bulk but of greater value. Goods can equally be misappropriated by people of
or high ranks. Suspicion as regards misappropriation of goods may arise fro
fluctuations in the rate of gross profit, turnover or percentage of manufacturing
These fluctuations can easily be noticed when compared with the bud
expectations.

Procedure for investigation of misappropriation of Goods :

The investigator should follow the following procedures :-

(a) He should study the internal control system in force in the organisatio
regard to the receipt and despatch of goods.

(b) He should check whether proper stock accounts are maintained or not.
why so and who are responsible for this work. He should examine all the re
related to the movement of goods.

(c) He should compare the purchases and opening stock figures with the fig
of sales and closing stock.

(d) He should find out that all the returns and allowances relating to purch
and sales of goods have been properly recorded.

(e) He should compare stock records with entries in the financial boo
ascertain that no fictitious purchases have been included in the boo
accounts.

3. Manipulation of Accounts :

Accounts are always manipulated by senior officers of the firm for s
particular object in view. All these deliberate manipulations in accounts are m
by obscuring the true position of the firm. The following may be the objects fo
manipulation of accounts:

(a) To evade and avoid income tax and other legal taxes.

(b) To receive large commissions by showing false profits.

(c) To attract a purchaser by showing enlarged profits.
(d) To prevent disclosure of poor financial position of the company.
(e) To pay higher rate of dividend, and
(f) To manipulate share prices in order to earn speculative profit.

The manipulation of accounts can be done by different methods. They are

NOTES

(a) Over and under – valuation of assets and liabilities.
(b) Omission of legitimate business expense.
(c) Charging Capital expenditure to revenue and vice versa.
(d) By showing fictitious sales, and
(e) By creating excessive provision for known liabilities.

Procedure of Investigation of Manipulation of Accounts

The Investigator should follow the following procedures –

(a) He should carefully examine all the connected documents thoroughly.
(b) He should also examine the internal control system in force and carry out a detailed checking of the purchases and sales transactions and the verification of different assets and liabilities.
(c) He should adopt the usual procedure of vouching and verification to trace such frauds.
(d) He should try to obtain information as much as possible from those sources, which can not be influenced by the organisation or its employees.

4.2 INVESTIGATION WHEN A RUNNING BUSINESS IS TO BE PURCHASED

Investigation on behalf of a prospective purchaser of a business is undertaken for the purpose of ascertaining the value of the business. The purchaser will like to know the true state of affairs and the probable future prospects of the business. He will mainly be connected with the profit earning capacity, financial stability and capacity of the business to meet obligations. Investigator in this case shall try to ascertain if the business is worth the purchase consideration as to the assets offered and the profit it is able to earn. The investigator should pay attention to the following points in his report :

(a) He should make a thorough enquiry into the reasons which cause the present proprietor to sell the business.
(b) He should find out whether the business requires particular skill or influence.
(c) He should make sure that the assets and liabilities have been properly valued.
(d) He should see that the assets and liabilities are shown in the balance sheet at their correct values and proper provision for bad and doubtful debts and depreciation has been made.
(e) The goodwill of the concern should be properly valued and the auditor should study the basis of its valuation.
(f) He should also see the present conditions of the various plants, and machineries. It will help him in finding out the future life of these important assets.

(g) He should examine the previous year's audit report if any.

(h) He should find out the amount of working capital and ensure that it is suffi to carry on the business.

(i) He should examine the condition of stock-in trade.

NOTES

(j) He should make full enquiries regarding the verification and valuation of st in trade. This item is subject to greater manipulation. Some times, the pr of a concern may be inflated by the following methods :

1. Inflation of closing stock
2. Inclusion of fictitious assets.
3. Omission of purchases
4. Omission of wages and other manufacturing expenses.
5. Making less provision for depreciation or less provision for bad and dou debts.

Adjustments to arrive at correct figures :

(a) The amount of debtors and creditors to be taken over should be thorou checked.

(b) He should examine the memorandum of Association. Articles of Associa and prospectus of the company.

(c) He should examine the rights attached to the different classes of sharehol of the company.

(d) He should also enquire about the rate of dividend which has been paid by company to its shareholders in the last three to five years.

(e) He should find and also make a correct value of the share from the s exchange.

(f) He should also make a correct valuation of all the assets and the liabiliti the company.

(g) He should also seek information regarding the price to be paid for the sh of the company.

The Investigator should make the following deductions and additions to figures of net profits as shown by the profit and loss account of the business.

Deductions from Profits :

1. Capital profits, i.e. profits on sale of investment or other fixed assets.
2. Income from assets not taken over by the purchaser.
3. Rent where purchaser is not going to purchase the business premises w belongs to the vendor of the business and for which no charge was ever m against the profits of the firm.
4. Business expenses if they are paid from private resources.

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Additions to Profits :

1. Capital losses or losses of exceptional nature not arising in the ordinary course of business.
2. Any capital expenditure charged to revenues.
3. Interest on borrowings when the purchaser is not expected to require them.
4. Excessive reserve for doubtful debts or depreciation or contingencies.
5. Charges not incidental to business.

It should be noted that the investigator will have full and easy access to all the books, vouchers and documents bearing on the period under review. After having investigated all these matters. The investigator will prepare a report for his client. The report should be clearly drafted and should reveal all the information so that the client may have full idea about the business he is intending to purchase.

SELF TEST

1. Define the term 'investigation' and explain its various features. Mention the circumstances under which investigation is necessary.
2. A fraud is suspected in a business and you have been asked to carry out an investigation. Explain briefly how would you proceed in the matter.
3. What special points will you bear in mind while carrying out an investigation on behalf of a person who wants to purchase a business as a going concern?

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UNIT – V : RECENT TRENDS IN AUDITING

STRUCTURE

5.0 Objectives
5.1 Cost audit
  5.1.1 Meaning
  5.1.2 Definition of Cost Audit
  5.1.3 Objectives of Cost Audit
  5.1.4 Commencement of Cost Audit
  5.1.5 Nature of Cost Audit
  5.1.6 Cost Audit Programme
5.2 Management audit
  5.2.1 Meaning
  5.2.2 Definition
  5.2.3 Objectives of Management Audit
  5.2.4 Management Audit Programme
  5.2.5 Benefits of Management Audit
  5.2.6 Limitations of Management Audit
5.3 The Cost Audit (Report) Rules, 1996

5.0 OBJECTIVES

After going through this lesion you will be able to

- Know what is Cost Audit and Objectives
- Know what is Management Audit and its objectives with its limitations

5.1 COST AUDIT

5.1.1 Meaning

It is an audit process for verifying the cost of manufacture or production o
article on the basis of accounts as regards utilization of material or labour or c
items of costs maintained by the company.

By the term 'Cost Audit' is meant the detailed checking of the costing sys
technique and accounts to verify their correctness and to ensure adherence to
objective of cost accountancy. It refers to verify the arithmetical accuracy of
accountancy entries in the books of account.

5.1.2 Definition of Cost Audit

R. W. Dobson in his book "Introduction to Cost Accountancy" defines it: "C
Audit is the verification of the correctness of cost accounts and of the adherenc
the cost accountancy plan".

According to the terminology of the Institute of cost and management accountants, England it is "verification of the correctness of cost accounts and of the adherence to the cost accounting plans".

5.1.3 Objectives of Cost Audit

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From the point of view of government

1. To find out whether any particular industry should be given any prize oR subsidy in order to encourage, develop and expand that industry.
2. The determine whether differential pricing within the industry is desirable.
3. To determine whether a particular unit requires protection and if such protection has already been given to it, should it be removed or should it continue.
4. To assist the Tariff Board to consider the extension or removal of protection.
5. For the purpose of comparison of cost between two companies engaged in the manufacture of identical goods to find uneconomic units and also to bring the certain industries of mischief under the section 209 and 233-B of the companies Act.
6. To find out the accuracy of the cost accounts to see that only chargeable items are debited to the cost accounts in the case of "Cost plus percentage contracts" to be entered into between the government and the manufactures.
7. To curb the profiteering by the manufacturing concerns.
8. To reduce the cost of essential commodities.
9. To fix the selling price in order to protect the interests of the consumers.
10. To avoid waste and unnecessary expenditure by the manufacturers and thereby reduced the cost of production to make available consumer goods at reduced rates.
11. To bring to light the fraudulent intentions of management.
12. To decide whether excise duty should or should not be reduced or removed on the finished goods.

From the point of view of manufacturers.

1. To aid the management to regulate production.
2. To enable the management to reduce the working costs by avoiding wastes.
3. To enable the management to chalk out the future policy on the basis of the report by the cost auditor especially in regard to labour, raw material, plant etc. to maximize production and reduce the cost of production.
4. To enable the management to choose economic methods of operations and thus earn profits to satisfy the shareholders and the investing public.
5. Cost analysis furnishes useful information in respect of such important matters, such as gross margin, differential costs, replacement costs etc.

6. To find the profitability of different units of the factory. In other words, the s
is a study of the productivity or measurement of efficiency of different pro
manufactured by the company.
7. To fix the price when tenders or quotations have to be sent, especially in
of competition.
8. To give up the production of less economic units and pay more attention
more profitable lines of manufacture.
9. To see the efficiency of the cost procedure introduced to avoid leaka
resources of the company. Their thefts, fraud and negligence.
10. To test the effectiveness of cost control techniques and to evaluate
advantages to the enterprise.
11. To test check the evaluation of inventory and work-in-progress at various s
of completion especially at the close of the financial year.
12. To have internal control and check which may in their turn be helpful
financial auditor.
13. To check wastage of materials and labour.
14. To fix the responsibility of an individual or of the management whe
inefficiency or wastage is found.
15. To get the up-to-date information whenever required for any purpose.
16. To value correctly the work-in-progress and the closing stock.
17. To test check important items of cost to find the accuracy of the cost fig
and their reliability.

5.1.4 Commencement of Cost Audit :

Before he begins the audit, the cost auditor should inquire whether ther
good and efficient system of internal check especially as regards the receip
issue of raw materials and stores to different departments, units or jobs. He sh
make the following inquiries :

1. Whether goods received notes for all the materials supplied by the supp
to the company are received and recorded.
2. Whether packages containing goods when received are opened in
presence of a responsible official of the company.
3. Whether all the materials received are entered daily in the Bin cards.
4. Whether the stores requisitions from different departments and sections
examined by the stores-keeper as regards the competency of
requisitionists.
5. Whether the stores and materials returned from different departments
sections are received by the store-keeper against stores debit notes.
6. Whether the stores and materials issued against the requisitions are ent
in the Bin cards daily.

7. Whether stores and materials returned from different departments and sections are recorded in the Bin cards.
8. Whether weighing machines in the stores department are regularly checked and properly maintained.
9. Whether known losses or shortages from whatever cause are reported at once to the authorities concerned.
10. Whether such losses are assessed by the inspectors whenever the loss or the damage is reported.
11. Whether such losses are written off by a responsible and authorized official of the company.

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5.1.5 Nature of Cost Audit

The following are some of the natures of cost audit :

1. To verify the arithmetical accuracy of cost accountancy entries in the books of account.
2. To find out whether the cost accounts have been properly maintained according to the principles of costing employed in the industry concerned.
3. To verify that the cost statements are properly drawn up as per the records and that they represent a true and fair views of the cost of production and marketing.
4. To find out whether each item of expenditure involved in the relevant components of the goods manufactured or produced has been properly incurred or not.
5. To find out whether the cost accounting procedures presenting procedures prescribed by the management have been adhered to or not.
6. To detect any error or fraud which might have been committed intentionally or otherwise.
7. To assist in reducing the amount of detail checking by the external auditor where the internal cost audit system is in operation.

5.1.6 Cost Audit Programme

The auditor should clearly understand the cost system in operation in the company concerned. The companies Act has not laid down the procedure in which the cost audit is to be conducted and what the cost auditor is expected to do. However the cost auditor should pay his attention to the following records.

A. Records of materials

1. The auditor should inquire whether the management has fixed the maximum quantity of raw materials which can remain in stock at any time to avoid over-stocking and thus locking up of the funds.
2. He should also inquire whether the minimum quantity or the ordering level has been fixed so that orders for raw materials should be placed in time to avoid storage of materials required for the manufacture of goods.

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3. He should compare the standard costs of different items in that stores with purchase prices. If the purchase price isis higher than the standard cost should inquire into the reasons for the purchases at higher prices.
4. He should check the stores and raw materials ledger with the delivery note goods received book and also with the gate-keeper's book, if one is in u
5. He should see whether the materials received as per delivery notes have b correctly recorded in the Bin cards as well as the stock register.
6. He should compare the stores requisitions with the Bin cards to see that th is no fictitious entry in the Bin cards. He should also see that the requisiti are according to schedule to avoid unnecessary piling up of materials in production department.
7. He should check the posting of the stores requisitions for direct materials the cost sheets.

B. Labour Records

1. The cost auditor should compare the attendance register of the workers the operational staff kept at the gate of the factory with the attendance regis maintained by the foreman of each department or section. He should comp the workers' attendance cards with the attendance register and the forema register. He should also examine the leave register.
2. If the wages are paid on piece rate basis, he should see whether pro records are maintained for the work done by the workers.
3. He should compare the piece work cards of the workers with the stock regis and the wages sheets.
4. He should enquire into the system of over time work put in by the workers e who is authorized to ask the workers to put in overtime work.
5. He should enquire whether extra payments are made in regard to incentiv in the form of bonus etc.

C. Records of Overhead Charges

1. He should enquire into the principles of allocation of overhead charges.
2. Whatever system of allocation of overhead charges is followed, he shou see that it is consistently followed. He should inquire the principle or basis which the overheads are allocated.
3. In order to see the accuracy of the overhead charges and their allocation different jobs, the auditor should check afew items.
4. He should reconcile the total over head expenses as per the different co sheets with the actual overhead expenses and if there is any difference discrepancy, he should make inquiry.
5. He should examine the method of apportioning factory costs to ensure tha is equitable to different jobs according to the principles laid down by th management.

D. Work-in-progress Records

1. The cost auditor should inquire into the principle of allocation of the overhead charges to the work-in-progress.
2. He should inquire the basis on which the work-in-progress has been valued. What method has been used to find the stage of the completion of the work-in-progress. Whether the method employed is satisfactory.
3. He should see that there has been no under or over-valuation of the opening work-in-progress which may result in showing more or less profits than actually they are.
4. He should see that whatever system of allocation of overhead charges had been adopted, it is followed consistently year after year.
5. He should see that the total value of the work-in-progress is not disproportionate to the finished goods. If it is so, he should ask for an explanation. If he is dissatisfied with the explanation he should mention this fact in his report.

E. In complete Contracts

1. The cost auditor should inquire whether measurement of works had been regularly obtained.
2. Whether there is any hazard which may cause a set-back or even cause a loss instead of the expected profit.
3. He should inquire whether raw material at the site had been lying there for unnecessarily long time before being used for the work.

F. Stores and Spare Parts Records

1. He should see whether appropriate records of stores and spare parts which are required for manufacturing purposes as regard their receipt, issue and balances, both in quantity and value have been maintained.
2. He should reconcile the value of issues and the balances of the stores and spare parts with the purchases.
3. He should see whether the value of stores and spare parts have been debited to proper head such as manufacture, repairs to plant and machinery, repairs to buildings etc.
4. He should check whether the value of stores and spare parts debited to manufacture have been further debited to different departments or manufacturing units or jobs or not.
5. He should check whether all charges upto the work such as carriage, customs, insurance etc, are included in the value of the stores and spare parts while valuing them at the date of the balance sheet.

5.2 MANAGEMENT AUDIT

5.2.1 Meaning

The term management audit implies an attempt to evaluate the performance of various management functions and processes with a view to improve its efficiency and productivity. It involves a detailed and critical evaluation as to what has been done by the management. It is an audit "to examine, review the various policies and actions of the management on the basis of certain objective standards".

5.2.2 Definition

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A comprehensive definition of management auditing is yet to evolve as the concept itself is quite new. However, the following are some definitions of management audit which helps in understanding it better.

According to the American institute of management "management auditing is a diagnostic appraisal process for analyzing goals, plans, policies and activities in every phase of operation to turnover unsuspected weaknesses and to develop ideas for improvement in areas that has escaped management attention".

A comprehensive definition of management audit has been given by Sherer and Kent. They state, "A management audit is an independent review and investigation which is concerned with the identification of those functional and operational areas where management has failed to achieve the required external standards of performance and with evaluation of management decision making with the aim of monitoring and improving the total efficiency and effectiveness of the organization".

Difference between management audit and statutory financial audit.

Basic	Management Audit	Financial Audit
1. Purpose	Its purpose is to review the management operations with a view to bring necessary improvements.	It's purpose is to find out whether the accounts present true and fair financial state of affairs of the concern.
2. Nature	It is a preventive as well as curative check. It is also evaluative and suggestive.	It is a post-mortem examination. It is also verifications.
3. Basis	It is based on financial as well non financial data derived from internal and external sources.	It is based on only financial data from internal sources.
4. Statutory provision	There is no statutory provision for undertaking the management audit. Hence it is not legally compulsory but discretionary.	It is legally compulsory and legal rules and regulations have to be observed for that.
5. Qualification	There is no prescribed qualification for the management auditor.	In this case, it can be undertaken by the chartered accountants only.
6. Process	A management auditor examines the management activities and operations and adopts operations management technique for the purpose.	A financial auditor examines financial accounts, statement and schedules and generally accepted audit techniques are applied for the purpose.
7. Precision	In it, only relative precision is necessary.	In it, absolute precision is quite necessary.
8. Area of study	In this case, the study may be related to the entire organization or part of it only.	In this case, it is necessary to examine the accounts of the entire organization.
9. Periodicity	There is no fixed period for which the management audit has to be undertaken. It may be every year or even after three to four years.	In this case, audit has to be undertaken every year.
10. Reporting	The management auditor is appointed by the management, hence he has to submit report to the management only.	The financial auditor has to submit report to the shareholders who appoint him.

5.2.3 Objectives of Management Audit

The management audit is carried on to satisfy the following objectives –

1. To reveal defects or irregularities in any of the elements examined by the management auditor and to indicate what improvements are possible to obtain the best results of the operations of the concern.
2. To assist the management to achieve the most efficient administration of the operations.
3. To suggest to the management the ways and means to achieve the objectives if the management of the organization itself lacks the knowledge of efficient management.
4. The management audit aims at achieving the efficiency of the management.
5. To help or aid the management, the management auditor is concerned with any phase of business activity which can be the basis of service to the management.
6. To aid the management at all levels in the effective and efficient discharge of their duties and responsibilities.

5.2.4 Management Audit Programme

Before the management auditor begins his work, he should chalk out the audit programme. It may be pointed out here that it is not necessary that he should rigidly adhere to the audit programme which he had chalked out. He has to use his imagination and judgement according to the circumstances of each case. The points to be considered in order to carryout management audit programme.

1. *Organization :* He should study the structure of the organization in the area of the management audit work assigned to him. In this connection he should compare the company's organization chart, if any.
2. *Plans and objectives :* He should discuss the plans and objectives of the concern with the management.
3. *Policies and practices :* He should find out whether the policies as laid down are properly adhered to whether any improvement can be made to the existing policies and practices so that they may be more effective.
4. *Systems and procedures :* He should study the systems and procedures with a view to find out whether there are certain defects in them. If he finds such a thing, he should suggest improvements to the existing systems and procedures.
5. *Controls :* He should find out whether those controls are adequate and effective. If not he should make suggestions to make them more effective.
6. *Operations :* He should ascertain whether there is any loophole in the working of the organization in connection with the manufacturing process which hinders the achievement of the maximum production.
7. *Layout and physical equipment :* He should study the existing layout and see whether any improvement can be made therein in order to take minimum advantage of it.

8. *Personnel* : He should see whether manpower is fully utilized or not. What ca be done to increase productivity. He should see whether there is co—operatio between the workers and the management. How can better and improve relationship between them be established.

9. *Regulations* : He should ascertain whether the concern complies with not onl its own rules and regulations and the companies act but also those of th municipal and local authorities.

The efficiency of the management audit will depend upon the managemen auditor as to how he handles the audit work, how cleverly and tactfully he extract information, how he conducts investigation and how he analyses the dat collected by him. He should bear in mind the following points while conductin audit : -

1. He should look for irregularities which might have been committed.
2. He should see whether there has been any conflict and any disagreemen amongst the members of the management about the planning, objectives an functions.
3. He should pay special attention to the cost element and obtain complete detail in regard to this element.
4. He should be alert for weaknesses in the organization systems, methods controls, objectives and personnel.

5.2.5 Benefits of Management Audit

Management auditing is becoming popular due to many advantages it offer in the improvement of the organization concerned. It helps the management in th following main areas :

1. **Plans :** *The auditor can assist in establishing and reviewing the system o planning in the organization. After reviewing the system of planning, he ca assist in developing orderly planning system, allocating responsibility fo planning.*
2. ***Decision – Making :*** The management auditor may help in reviewing th mechanism of decision-making and find out whether sufficient information i available to the management for the purpose.
3. ***Authority structure :*** The management auditor may help the management i proper designing of the authority structure including rendering assistance i strengthening and expending the flow of information between the responsibilit centres.
4. ***Effective communication :*** He can assist the management in establishmen of effective communication network and bring about necessary improvemen in this regard.
5. ***Results measurement :*** The management auditor may assist the management in establishing acceptable standards to judge the results and pinpoint the key areas or functions in the profit-making process.

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6. *Overall improvement :* The management auditor may suggest suitable constructive measures to the management so that desirable change may be brought about.
7. *Development Human Resources :* In every organization, it is the human resource which is quite crucial and important and sufficient measures must be taken to develop people.
8. *Relieves pressure on management :* The important job or review and appraisal is undertaken by the management auditor and the management is relieved of the pressure and thus it may give more attention to other important and special matters.

5.2.6 Limitations of Management Audit

The following are the important limitations of management audit --

1. **Not regularly undertaken :** The management audit is not undertaken regularly and on that account it may not bring necessary improvements in the interval period.
2. **Lack of expert knowledge :** The management audit is a highly complex job and it requires inter-disciplinary knowledge and specialized skill on the part of such auditor.
3. **Costly :** The management audit is a very costly affair and all business firms cannot afford it.
4. **Lack of Intensive study :** Normally, such audit is undertaken by large concerns and in those cases it is not possible to undertake intensive study of all the managerial operations.
5. **Lack of suitable standards :** For objective assessment it is quite necessary to develop suitable acceptable standards. In practice, it is not an easy task to develop such standards and with the result, the conclusions arrived at may not be acceptable.
6. **Ineffective recommendations :** Often the recommendations may be given casually or carelessly. In that case, the desired results may not be obtained.
7. **Improper implementation :** The job of the management auditor is over after submitting the report to the management. If the management does not implement the recommendations effectively, the very objective of the management audit may be jeopardized.
8. **Degree of independence :** It is doubtful whether the management auditor may remain quite independent in the review and examination of the operations of the management audit. In actual practice he may not be in a position to assess the competence of the other managers independently.
9. **Competence judgement :** It is the main duty of the management auditor to see how competently the management is getting the plans executed and implementing controls. But, it has been found in practice that individual competence is not judged properly.

5.3 THE COST AUDIT (REPORT) RULES, 1996

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In exercise of the powers conferred by sub-section (4) of section 233-B, read with sub-section (l) of section 227 and clause (b) of sub-section (l) of section 642 of the Companies Act, 1956 (1 of 1956), and in super session of the Cost Audit (Report) Rules, 1968, except as respect things done or omitted to be done, before such super session the Central Government hereby makes the following rules, namely :

1. ***Short title and commencement:***

(1) These rules may be called the Cost Audit (Report) Rules, 1996.

(2) They shall come into force on the date of their publication in the Official Gazette.

2. ***Definition. In these rules, unless the context otherwise requires :***

(a) "Act" means the Companies Act, 1956 (1 of 1956);

(b) "Cost Auditor' means an auditor appointed under sub-section (1) of section 233-B of the Act;

(c) "Form" means the Form of Cost Audit Report specified in the Schedule; and includes Annexure to the Cost Audit Report and Proforma specified in the Schedule'.

(d) "Product under reference' means the product to which the rules made under clause (d) of sub-section (1) of section 209 of the Companies Act, 1956 (1 of 1956) apply;

(e) "Schedule" means Schedule annexed to these rules;

(f) All other words and expressions used in these rules but not defined, and defined in the Act and rules made under section 209 of the Act shall have the same meanings respectively assigned to them in the Act or rules, as the case may be.

3. ***Application:***

These rules shall apply to every company in respect of which an audit of the cost accounting records has been ordered by the Central Government under sub-section (1) of section 233-B of the Act.

4. ***Form of Report***

(1) Every Cost Auditor who conducts an audit of the cost accounting records of the company shall submit a report in triplicate to the central Government in the Form (including Annexures and Proforma) in accordance with the procedure specified in the Schedule annexed to these rules and at the same time forward a copy of the report to the company.

(2) Every Cost Auditor, who submits the report under sub-rule (1) shall also give clarifications, if any, required by the Central Government on the Cost Audit Report submitted by him, within thirty days of receipt of the communication addressed to him calling for such clarifications.

5. ***Time limit for submission of report.***

The Cost Auditor shall send his report referred in sub-rule (1) of rule 4 to the Central Government and to the concerned company within one hundred and eighty days from the end of the company's financial year to which the Cost Audit Report relates.

6. ***Cost auditor to be furnished with the cost accounting records, etc.***

(1) Without prejudice to the powers and duties the Cost Auditor shall have under sub-section 4 of Section 233-B of the Act, the company and every officer thereof including the persons referred to in sub-section (6) of section 209 of the Act, shall make available to the Cost Auditor within ninety days from the end of the financial year of the company such cost accounting records, cost statements, other books and papers that would be required for conducting the cost audit, and shall render necessary assistance to the cost auditor so as to enable him to complete the cost audit and send his report within the time limit specified in rule 5.

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(2) If the cost accounting records, cost statements, other books and papers are not made available by the company within the time limit specified in sub-rule (1), the Cost Auditor shall intimate the fact of not having made available to him such records, statements, books and papers to the Central Government within ten days after expiry of time limit of ninety days specified in sub-rule (1).

7. ***Penalties***

(1) If default is made by any Cost Auditor in complying with the provisions of rule 4 or rule 5, he shall be punishable with fine which may extend to five hundred rupees.

(2) If a company contravenes the provisions of rule 6, the company and every officer of the company including the persons referred to in sub-section (6) of Section 209 of the Act, who is in default, shall, subject to the provisions of section 233-B of the Act, be punishable with fine which may extend to five hundred rupees and where the contravention is a continuing one, with a further fine which may extend to fifty rupees for every day after the first day during which period such contravention continues.

8. Saving of action taken or that may be taken for contravention for the Cost Audit (Report) Rules, 1968- It is hereby clarified that the super session of the Cost Audit (Report) Rules, 1968, as amended from time to time, shall not in any way affect –

(i) any right, obligation or liability acquired, accrued or incurred there under;

(ii) any penalty, forfeiture or punishment incurred in respect of any contravention committed there under;

(iii) any investigation, legal proceeding or remedy in respect of any such right, privilege, obligation, liability; penalty, forfeiture or punishment as aforesaid, and any such investigation, legal proceedings or remedy may be instituted, continued or enforced and any such penalty, forfeiture or punishment may be imposed as if those rules had not been superseded.

SCHEDULE [See – 2(e) and rule 4] Form of Cost Audit Report [See – 2(c) and rule 4]

I/We ....having been appointed as Cost Auditor(s) under Section 233-B of the Companies Act, 1956 (1 of 1956) .... (mention name of the company)

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have its referred to as the company), have examined the books of accounts prescribed under clause (d) of sub-section (1) of Section 209 of the said Act, and other relevant records for the year ended .... (mention the financial year) relating to .... (mention name of the product) maintained by the company and report subject to my/ our comments under the heading "Auditor's Observations and Conclusions" contained in the Annexure to this report, that –

(a) I/We have not obtained all the information and explanations which to the best of my/our knowledge and belief were necessary for the purpose of this audit :

(b) Proper cost accounting records as required under clause(d) of sub-section (1) of Section 209 of the Companies Act, 1956 have/have not been kept by the company;

(c) Proper returns adequate for the purpose of my/our Cost Audit have/have not been received from branches not visited by me/us;

(d) The said books and records give/do not give the information required by the Companies Act, 1956 (1 of 1956) in the manner so required;

(e) In my/our opinion, the company's cost accounting records have/have not been properly kept so as to give a true and fair view of the cost of production, processing, manufacturing or mining activities, as the case may be, and marketing of the product under reference; and

(f) The cost statements in respect of product under reference as specified in the Annexure/ proforma of Schedules I and II of the Cost Accounting Records (.....................) Rules duly audited by me/us are/are not kept in the company.

The matters contained in the Annexure and Proforma to this report form part of this report, which is also subject to my/our observations made therein.

Dated this .... date of .... 20.......at ....

(Mention name of place of signing this report).

COST AUDITOR(S)

NOTE: 1. Delete inapplicable words.

2. Specify the title of Cost Accounting Records rules made under clause(d) of sub-section (1) of section 209 of the Companies Act, 1956 which are applicable to the product of the company.

SELF TEST

1. What do you mean by Cost Audit?
2. Lay down the procedure in which the cost audit is to be conducted.
3. What is 'Management audit'? How it differ from financial audit.
4. What is 'Management audit'? Describe its various benefits and limitations.
5. What are the objectives of management audit? What points are to be considered while carrying out a management audit program.

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