B.Com.

Third Year

Core Paper No. 14

AUDITING

BHARATHIAR UNIVERSITY

SCHOOL OF DISTANCE EDUCATION

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(Syllabus)

Core Paper 14

B.Com. Auditing

Objectives : To familiarize the students with the principles of auditing.

Unit – I

Auditing– Origin – Definition – Objectives – Types – Advantages and Limitations – Qualities of an Auditor – Audit Programmes.

Unit – II

Internal Control – Internal Check and Internal Audit –Audit Note Book – Working Papers. Vouching – Voucher – Vouching of Cash Book – Vouching of Trading Transactions – Vouching of Impersonal Ledger.

Unit – III

Verification and Valuation of Assets and Liabilities – Auditor's position regarding the valuation and verifications of Assets and Liabilities – Depreciation – Reserves and Provisions – Secret Reserves.

Unit – IV

Audit of Joint Stock Companies – Qualification – Dis-qualifications – Various modes of Appointment of Company Auditor – Rights and Duties – Liabilities of a Company Auditor – Share Capital and Share Transfer Audit – Audit Report – Contents and Types.

Unit - V

Investigation – Objectives of Investigation – Audit of Computerised Accounts – Electronic Auditing – Investigation under the provisions of Companies Act.

Books for Reference

1. **B.N. Tandon, "**Practical Auditing" ,S Chand Company Ltd
2. **F.R.M De Paula**, "Auditing-the English language Society and Sir Isaac Pitman and Sons Ltd,London
3. **Spicer and Pegler, "**Auditing: Khatalia's Auditing"
4. **Kamal Gupta, "**Auditing " , Tata Mcgriall Publications

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UNIT- I

LESSON-1

AUDITING

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1.0 AIMS AND OBJECTIVE

This unit is consisting of basics of auditing, evaluation of auditing, how it is differentiated with book keeping, accounting, and also investigation. Here there is an elaborate discussion on objects of auditing. Auditing also classified under two major categories are discussed. Then what are all the advantages and limitations are explained. This unit ends with the discussion about qualities and qualifications of auditing.

1.1 INTRODUCTION

Auditing is a system of check upon persons who, in the course of their work, handle receipts and expenditure of money belonging to others. It has been in practice since time immemorial. There is historical evidence suggesting that household accounts of early rulers were kept by at least two persons, independently of one another, to keep a check on mistakes and misappropriations. In the Mauryan, Greek and Roman empires, there was a fool-proof system of control over public revenue and expenditure.

Private business houses and estates were also subject to audit examinations though, due to small number of transactions and crude methods of accounting, such examination was quite simple and brief. The person appointed to exercise the check would only hear the business records as read out to him by the accounting parties. That explains the origin of the world "audit" derived from the lain audire, i.e., to hear.

1.1.1 Origin of Auditing and Evolution

The Renaissance in Italy in the fifteenth century, led to a rapid growth of industry and commerce. Due to increase in the number and complexity of business transactions, there was an ever –growing need to ensure an independent and expert review of the accuracy and reliability y of business records.

An independent review of the accounts of business enterprises became still more necessary after the advent of the joint stock company, marking separation between the ownership and management of business. Thus, professional auditing received statutory recognition with the passing of the British Companies Act in 1862, and "detection of fraud" became the primary objective of auditing. In the United States, professional auditing was introduced in 1900 and ascertaining of "actual financial condition earning of an enterprise," was set out as the main objective of auditing.

1.1.2 Early developments in India

In India, the law relating to auditing followed the British model, the joint Companies Act of 1857, made a provision for an optional annual audit of companies.

Compulsory audit in the case of companies was introduced by the Companies Act of 1913, with specific provisions as to maintenance of books of account, contents of the Balance Sheet, etc. Qualifications, duties and rights of the auditor, including the procedure of his appointment, were also legally prescribed. Accordingly, only a person holding a certificate from the local Government, or a member of an association or society duly recognized for this purpose, could act as an auditor. In 1918, the Government of Bombay initiated a scheme for training of professional accountants and those passing the examination were awarded the Government Diploma in Accountancy (GDA). Persons holding the GDA could practice accountancy throughout the British India.

In 1930, the accounting profession was brought under the control of Central Government to ensure uniformity in standards throughout the country. The Central Government maintained a Register of Accountants and also established the Indian Accountancy Board to advise it on matters relating to the profession.

1.1.3 Post independence developments

In, 1949, Parliament enacted the Chartered Accountants Act whish has vested the management and control of the accounting profession the members of the profession itself. Accordingly the Institute of Chartered Accountants of India (ICAI) has been set up under the Act. The affairs of the ICAI are managed and controlled by a Council comprising elected representative of charted accountants and nominees of the Central Government. The Council lays down standards of education, training, professional conduct and discipline. The ICAI has issued a number of Statements on Auditing, Statements on Standard Auditing Practices (SAPs) and Accounting Standards (AS) for guidance of the members of the persons.

The Companies Act 1956 has made additional provisions as regards maintenance of accounts and audit. Accordingly, only independent persons duly qualified and trained in the profession can act as statutory auditors in the case of company. The scope of duties, rights and liabilities of the auditor and requirements as to annual accounts and the audit report, have also been enlarged.

The Companies Act 1956, also prescribes a cost audit it the case of specified companies to be conducted by a cost and works accountant within the meaning of the Cost and Works Accountants Act of 1959.

The Income-tax Act 1961, has made the audit of accounts of certain assesses compulsory, which has further contributed to the growth of the profession.

1.2 MEANING AND DEFINITION OF AUDITING

In the main, auditing is concerned with verification of accounting and financial records with a view to determining their accuracy and reliability.

Some important definitions of auditing may now be examined:

Institute of Chartered Accountants of India: "Auditing… is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report."

Spicer and Pagler: "An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditors to satisfy that the Balance Sheet is property drawn up, so as to give a true and fair view of the state of affairs of the business, and whether the Profit and Loss Account gives a true and fair view of the profit and loss for the financial period, according to the best of his information and the explanations given to him and as shown by the books, and if not, in what respects he is not satisfied."

F.R.M. De Paula : "An audit denotes the examination of Balance Sheet and Profit and Loss Account prepared by others together with the books, accounts and vouchers 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 the particular concern, according to the information and explanations given to him and as shown by books."

1.2.1 Important features of audit

The main features of an audit may be summed up as follows:

Examinations of books, statements: An audit is a critical examination of the books of account and the financial statements drawn from them, including all operations and performances, whether financial or otherwise. In the view of the Institute of Chartered Accountants of India, auditing is not merely restricted to accounting records but extends to areas such as managerial performance, cost records, etc.,

… by a properly qualified person … An audit examination can only be made by a person (or group of persons) who is duly competent for the purpose. Only a person who possesses the prescribed qualifications and who is wholly independent of the client will be deemed as competent. The criteria of qualifications and independence have been laid down in the Companies Act of 1956.

… on the basis of proper evidence … An audit examination is to be made on the basis of evidential documents such as invoices, money receipts and other records, including information and explanations supplied by authorized representatives of the client. It is the duty of the auditor to carefully assess and evaluate every piece of evidence relevant for his examination.

… to express his opinion as to the truth and fairness of assertions in statements, financial accounts. The object of the audit examination is to enable the auditor to express his opinion as regards the truth and fairness of the financial statements prepared by his client. To this end, be must ensure – (a) that the books of account have been maintained as required by law, if any; (b) that the Profit and Loss Account (or Income and Expenditure Account) gives a true and fair view of the profit or loss of the business for the period under review, and the Balance Sheet (or the statement of Affairs) gives a true and fair view of assets and liabilities of the business on the closing date.

1.3 DEVELOPMENT OF AUDITING

Over the years, there has been an impressive growth in terms of the scope, objects and techniques of auditing as well as duties, rights and legal status of the members of the profession. This has been due to several factors, important among which are as follows:

1. Increase in size and complexity of business organizations

Due to increase in the number and complexity of business units following the Industrial Revolution, new techniques of auditing have been developed to verify a multitude of transactions. For example, as detailed checking of every transaction is time consuming, the auditor increasingly relies on a sample checking i.e., detailed checking of only a limited number of scientifically selected transactions, after satisfying himself as regards the internal control system adopted by the business under audit.

Since the audit report is relied upon by a variety of people both inside and outside the business under audit, it is only proper that the auditor is completely independent of the business under audit, such that his opinion, as expressed in his report regarding the results of operations as also the financial condition of the business, is free from any bias or partiality. Notable among the developments which have taken place to ensure independence and objectivity on the part of the auditor, are provisions in the Companies Act 1956, as also the code of conduct formulated by the Institute of Chartered Accountants of India.

2. Divorce between ownership and management

Evolution of the joint stock company has resulted in separation between ownership (shareholders) and management (directors) of the affairs of the business. For the shareholders, the financial statements periodically submitted by management are the only source of information as to the state of the company’s affairs. However, they may not possess the required expertise to understand the information presented in the financial statements. In the circumstance, there has been growing realization of the need for an independent an competent examination of books of account and financial statements of the company so as to ascertain the truth and fairness of the assertions made therein.

3. Legislative control

There are several laws to ensure that business undertakings function within the framework of the norms as standards laid down by the Government in the interest of public policy, adding to the development of auditing. The Companies Act 1956, for example, has made elaborate provisions for maintenance of requisite books of accounts by companies, qualifications of auditors, manner of their appointment and duties, rights and liabilities.

4. Judicial pronouncements

The Courts have imposed exacting obligations on the auditors to conform to the statutory requirements as to presentation of financial statements and reporting standards. This has considerably enlarged the scope of liabilities of auditors.

5. Statements and standards by professional bodies

The Institute of Chartered Accountants of India (ICAI) has issued a number of Statements on Auditing, Statements on Standard Auditing Practices (SAPs) and Accounting Standards (AS) for guidance of auditors in India. The International Federation of Accountants has also issued several documents which have significantly contributed to the growth of the profession.

6. Electronic data processing (EDP)

Lately, it has become common for business undertakings to use electronic computers to process transactions, maintain data files, prepare trial balances and other accounting and operating analyses and reports which significantly affect accounting information used by the auditor for his examination. The auditor has often to rely on the EDP applications of the client to determine the nature, timing and extent of audit tests. This has led to development of several new techniques to assess the risk factors associated with EDP and formulate appropriate audit plan.

1.4 DISTINCTION BETWEEN ACCOUNTANCY & AUDITING

Book-keeping:

Book-keeping is concerned with keeping a regular, correct and systematic record of day-to-day transactions of an enterprise in suitably ruled books of account. It includes – (a) entering the transactions in various books, such as Purchase Day Book, Sales Day Book, etc., (b) posting them to the relevant accounts in the ledger and (c) totaling those accounts. Much of the work of a book-keeper is clerical in nature and it is performed under overall direction and supervision of an accountant.

Accountancy begins where book - keeping ends. Accountancy in concerned with – (a) checking the work done by the book – keeper, so as to ensure that all financial transactions have been correctly recorded I the books of account; (b) preparing a trial balance to see

that effect of each transaction has been recorded in relevant accounts in the ledger, (c) preparing financial statements such as Profit and Loss Account and Balance Sheet to communicate the results of business operations and financial condition to interested parties; (d) passing adjustment and rectification entries; and (e) designing a suitable accounting system to protect the business assets from unauthorized ad improper use and to comply with legal requirements under the income – tax, sales – tax, company laws, etc.

Auditing:

Auditing in concerned with making an analytical and critical examination of the books of account, checking and verification of evidence in support of entries appearing the books of account, and ascertaining the authenticity of assertions in the financial statements. The most important duty of an auditor is to report whether, is his opinion, the Profit and Loss Account represents a true and fair picture of the profit or loss, and the Balance Sheet, a true and fair picture of the financial position of the business.

According to Mautz and Sharaf, "The relationship of auditing to accounting is close, yet their nature is very different; they are business associates, not parent and child". The main points of distinction between accountancy and auditing may be recounted as follows:

Accountancy	Auditing
1. It is concerned with collection, classification, summarization and communication of financial data.	1. It is concerned with analytical and critical examinations of the financial records and statements.
2. It measures business events in terms of profit or loss and communicates the the financial condition of the business.	2. It reviews the measurement and communication of financial results and condition.
3. The accountant is an employee of the enterprise, entitled to regular salaries.	3. The auditor is an independent and Professional competent outsider, whose services are hired for a fee.
4. The accountant may or may not have any knowledge of audit techniques and procedures.	4. The auditor must know the Principles and techniques of accounting.
5. The accountant is not required to submit a report on the financial statements prepared by them.	5. The auditor is required to submit a report containing his opinion as to the truth and fairness of assertions made in the financial statements.
6. The accountant, being an employee, ordinarily works on a permanent basis.	6. The auditor has to be appointed every year.

1.4.1 Where an auditor acts as accountant

Sometimes, the auditor may be required to perform duties on n accounting nature such as preparation of final accounts, computation of taxable, income, etc. In India, it is customary for the chartered accountants to be retained for this purpose.

However, in the course of performance of accounting duties, the auditor works purely and simply as an accountant, accepting at face value the figures and information fathered from the books of account, or supplied by his client. He cannot be held liable if the assertions in the statements or returns prepared by him are subsequently found to be incorrect.

In Mrs. Apfel v.Annan Dexter & Co. (1926), the auditors, who had been appointed to prepare tax returns, were accused of being negligent as they had failed to discover wrongful over drawings made by Mrs Apfel's sons employed by the business. The Court rejected the charge and accepted the auditor's defense that they were only employed as accountants to prepare Mrs Apfel's income-tax returns, and to do more.

In Leech v. Stokes and others (1937) also, the auditors were appointed to prepare annual Profit and Loss Account for submission to tax-authorities. Given the nature of their duties, the Court held them nor liable for a subsequent discovery of misappropriation of cash by employees of the client.

1.5 DISTINCTION BETWEEN INVESTIGATION & AUDITING

An investigation means an enquiry or examination with a fixed object e.g., detection of a suspected fraud, ascertainment of causes of low productivity, continuing losses, high labour turnover, turnover, inadequate working capital, etc., or evaluation of the work of running business. It may be made on behalf of owners, prospective investors or, in the case of a company, the Central Government.

The points of distinction between an investigation and audit are as follows:

Scope

The scope of an investigation is determined by the objects intended to be achieved by the party on whose behalf investigation is undertaken. For example, investigation into the causes of low productivity will only focus on factors such as availability and quality of raw material, competence, morale and stability of tenure of workers, and so on. Investigation to evaluate the work of a business will be concerned with the value of the assets, and reserves and liabilities of the business, together with its potential and prospects.

An audit examination, on the other hand, extends to all factual assertions in the financial statements with a view to ascertaining their truth and fairness. In a statutory audit, the scope of audit cannot be curtailed, though in an optional audit this can be done, but in that case the auditor cannot be held liable for fraud or error in any area which is outside the purview of his examinations.

Object

Investigation is aimed at ascertaining certain facts, such as fraud, tax liability, value of shares, or causes of an existing situation such as low productivity, high labor turnover, inadequate working capital, continuing losses, etc. It may also have the object of evaluating the worth of the business from the point of view a prospective buyer, investor, etc.

The object of an audit is to critically examine and make a report on the truth and fairness of assertions made in the financial statements as to the results of operations (profit or loss) and the state of affairs of the business (position of assets and liabilities)

Time coverage

The period covered by an investigation is determined by reference to its objectives. It may be as brief as a few weeks, or extend to several years. The party on whose behalf and investigation is undertaken may change the period even during the course of investigation. However, an audit examination generally covers the accounting year of the client, though in the case of a company it may comprise fifteen months.

Approach to work

An investigation is aimed to achieve specific objectives. The information required for the purpose may not be really available. In the circumstance, inquiry for the necessary evidence will have to go beyond the books and records. This will require the investigator to be alert and critical enough to identify the clues for getting at the truth. Unlike the auditor, he need not accept any fact or figure at its face value. He must subject it to a close scrutiny. Only after careful analysis of the relevant evidence, he can develop it to serve the interests of his client.

The auditor, on the other hand, only examines and reviews the financial statements prepared by his client. His objective is of a general nature, namely, to express his opinion on the authenticity of the financial statements. In his case, the standards of strictness of enquire are not as demanding as in the case of an investigator. He is also not expected to go into the minutest detail of every aspect of his work. He accepts any fact or figure at its face value, unless there is something apparently suspicious which calls for deeper examination. It is true that the current requirements as to reporting oblige him to proceed with his work somewhat in the manner of an investigator, but he cannot be held liable if, in the absence of anything to the contrary, he accepts ay prima facie evidence as true and fair.

Work programme

It may not be possible to provide a standard work programme for an investigation. Even it may not be possible to devise and identical programme for two specific investigations of the same nature. In each case, the programme will depend on the availability of the required information and this will be determined only as the work proceeds. In fact, at the completion of each stage of work, the programme may have to be reviewed.

In an audit, however, the work programme is generally fixed and even where it is flexible; there are variations only in emphasis, but rarely in form.

Disclosure requirements
There are no legal requirements as to disclosure of information in and investigation. The investigator may rearrange the existing data, redraft the accounts, develop new data and provide support for a particular viewpoint. However, the auditor is legally required to ensure complete disclosure of the information as prescribed.

Report
The investigator reports to the persons on whose behalf he has undertaken his work. His report is by way of conclusions drawn by him after an inquiry into the specific facts and circumstances. He is not required to adhere to any standard form or pattern in the matter of reporting. He need not render any opinion of his own, but he should provide adequate material to enable his client to make a correct judgment. For example, in an investigation on behalf of an intending buyer of business, he need not say whether the business is worth purchasing, or whether it is worth the price demanded. These questions are best left to be decided by the buyer himself. But since the investigation report will form an important basis for judgment by the buyer, the investigator should present his conclusions and the evidence supporting them, in a clear and cogent manner so that the buyer may be able to form a correct judgment.

An auditor reports to owners of the business. His report follows a standard form and is concerned with facts and circumstances which, in an optional audit, are stated in the letter of his engagement and, in the case of statutory audit, in the statute concerned. He only expresses his opinion as to the authenticity of assertions made in the financial statements and is not required to present evidence is support thereof.

1.6 OBJECTS AUDIT

Evolution of the objects of auditing has followed the evolution of the business organization itself. In the early period, for example, due to a small size and simple operations of business, audit examination was largely concerned with detection of fraud by employees. The auditor was only responsible to the owners(s) of the organization, and outsiders had neither any stake nor interest in the affairs of the enterprise.

The Industrial Revolution led to a significant increase both in the size and complexity of business operations. Increasing capita requirements of business led to the birth of a new form of organization, namely the joint stock company, marking separation between ownership and management. Business enterprises, acquired considerable economic significance and many outsiders, eg. Bankers, investors, creditors, government agencies s well as the public in general, came to develop great stakes in the financial sell-being of the enterprises.

All these developments created a new awareness of the need for an independent opinion as to the fairness of the financial statements provided by management. The larger the enterprise and the more remote the parties whose interests coincided with it, the greater became the value of an independent opinion. The much-desired revision in the objective of auditing followed, such that now the emphasis shifted to rendering an opinion of the truth and fairness prepared by the management. Fraud detection, which was for long the primary objective of an audit, was relegated to the second position.

1.6.1 Evolution of Objectives and Techniques of Auditing

Period	Stated audit Objectives	Extent of Verification	Importance of internal control
Ancient – 1850	Detection of fraud	Detailed	Not recognized
1850 - 1905	Detection of fraud Detection of clerical errors	Some tests, primarily detailed	not recognized
1905 – 1933	Determination of fairness of reported financial position. Detection of fraud and errors	Detailed and testing	Slightly recognized
1933 – 1940	Determination of fairness of reported financial position. Detection of fraud And errors	Testing	Awakening of interest
1940	Determination of fairness of reported financial position	Testing	Substantial emphasis

(Source : The Accountant, October, 1962)

The objects of audit may be stated as follows:

Primary : 1. To examine the reliability and validity of the financial statements so as to render an opinion of the truth and fairness of the presentation in those statements.

Secondary: 2. Detection and prevention of errors, and fraud.

1.6.2 Opinion as regards financial statements

According to SAP –2 issued by the Institute of Chartered Accountants of India (ICAI), the objective of audit of financial statements is to enable the auditor to express his opinion as regards the truth and fairness of assertions made in those statements. Sec.227 of the Companies Act requires a company auditor to state whether in his opinion – (a) the Balance sheet of the company gives a true and fair view of the state of the company's affairs as the end of its financial year; and (b) the Profit and Loss Account gives as true and fair view of the profit or loss for its financial year.

To be able to render an opinion, the auditor must first make satisfactory examination of the financial statements ad the accounts and records prepared as per the Accounting Standards (AS) and Standard Auditing Practices (SAPs) issued by the ICAI, and the statutory requirements if any. While making such examination, the auditor is and must, in fact and appearance, act as an independent and professional reviewer. Auditor's independence means freedom form any control and influence of interested parties such as the client-organization, its management and owners. His professional expertise will enable him to exercise due care in selecting appropriate procedure and techniques so as to ascertain that the financial data under examination, as prepared and submitted by his client, are a fair representation of what they claim to represent.

Rendering an opinion on the truth and fairness of the financial statements is legally compulsory in the case of a company auditor and the auditor of a banking company, an insurance company and a cooperative society, and optional for non-company auditors, unless the terms of their appointment or the laws applicable to the business units or institutions under audit, provide otherwise.

The auditor's opinion is only with respect to the truth and fairness of the assertion as to financial position of the enterprise as made in the Balance Sheet and results of its operations as stated in the Profit and Loss Account. It is not as assurance as to the future viability of the enterprise or efficiency and effectiveness with which the management has conducted the affairs of the enterprise.

1.6.3 Detection and prevention of errors

According sot SAP-4, "Fraud and Error" issued by the ICAI, an error may be defined as any unintentional mistake or mis-description in the books of account or records whether by way of – (a) mathematical or clerical mistakes in the records and data; (b) oversight or misinterpretation of facts; or (c) misapplication of accounting policies. An error is generally taken to be innocent and not deliberate. Where it appears to be willfully made, it assumes the character a fraud.

Errors may be classified as follows:

1. Clerical errors, which may be further, classified into: (a) errors of omission, and (b) errors of commission.
2. Errors of principle.
3. Compensating errors.
4. Errors of duplication.

1.6.4 Clerical errors:

A clerical error may be committed in the course of – (a) recording a transaction in the books of original entry such as Purchases Book or Sales Book; (b) posting a transaction to the ledger: or (c) totaling or balancing of a ledger account. It may be an error of omission or commission.

Error of omission: It occurs when a transaction is not recorded in the books of account, either wholly or partially. Where a transaction in altogether omitted from the record, the error may be difficult to detect. Because, as the transaction has not been posted to the ledger, it will not affect the agreement of trail balance. For example, if a credit purchase is not entered in the Purchases Day Book, it will not be posted to the related ledger account, namely, on the debit side of the Purchase Account and on the credit side of the Supplier's Account. The trial balance will not be affected by the omission. An error of this type can only be detected by an intensive checking of the Purchase Book and the Stock Book.

However, it a transaction has been partially recorded in the course of its posting to the ledger, the errors can be easily detected because it will throw out the trial balance. For example, if a credit sale has been credited to the Sales Account but not debited to the Buyer's Account, the trial balance will register excess credit by the amount of the sale and then it should not take long to discover the error.

Error of commission: It may be committed either at the stage of recording a transaction in a book of original entry or while posting it to the ledger. Errors in totaling and balancing of accounts or in carrying forward totals to the trial balance, are also called errors of commission. The following are the examples of such errors:

(a) Where a transaction has been incorrectly recorded either wholly or partially, e.g., if a credit purchase of Rs.250 has been recorded in the Purchases Day Book as Rs.250 (such an error will not affect the trial balance.)

(b) Where a transaction has been incorrectly posted to the ledger e.g., if a credit sale of Rs.250 is entered in both the concerned accounts (on the debit side in the Customer's Account and on the credit side in the Sales Account) as Rs.520 Such an error will also not affect the trial balance. But it the error is by way of incorrect posting in one account, the

other account being correctly posted, the trial balance will reveal it by showing excess debit or excess credit. The same will b the case where the posting is made only in one account and not in the other.

(c) Where ledger accounts are incorrectly totaled or balanced. Here, in either case, the trial balance will be affected, making the error that much easy to detect.
(d) Where an error is made in entering balance in the trial balance. In this case also, the error will be reflected in the disagreement of the trial balance.

1.6.5 Errors of principle:

An error of principle occurs when the generally accepted principles of accounting are not observed while recording any transaction in the books of account. This may be due to inadequate understanding of the principles on the part of the recording clerks. But sometimes the overlooking of the principles may be with an intention to conceal the real state of affairs of the business by way of overstatement or understatement of profits or losses.

The following re some examples of the errors of principles:

(a) Where items of revenue expenditure are shown as capital expenditure or vice-versa. Revenue expenses are a charge on profits and should have the effect or reduction in profits. If any such expense is treated as capital expenditure, e.g., where the amount of current repairs to machinery is capitalized, it will have the effect of increasing the profits and also the book value of the machinery. In such a case, the Profit and Loss Account would not reveal a true and fair picture of the results of operations, nor would the Balance Sheet show a true and fair picture of financial position of the business.

Sometimes, incorrect allocation between capital and revenue expenditure may be used to reduce profits, e.g., by showing capital expenditure as revenue and a charge on profits. The result in this case will also be distortion of the profits and financial position of the business.

(b) Where the identity of an item of expenditure camouflaged. It will happen when, to short-circuit legal requirements or for any other reason, expenditure is shown under a different account, e.g., wages being debited to Advertising Account, or advertising expenses being debited to Repairs Account. While the expenditure in such a case would constitute a charge on the profits, but it would falsify and distort the financial statements.

(c) Where expenditure is shown as benefit granted. It happens where interest paid to a creditor is debited to his personal account, such that instead of constituting a change on the profits, it results in enhancing the assets position.

(d) Where valuation of assets is not as per generally accepted accounting principles. It may be done to overstate or understate the profits and financial position of the business.

1.6.6 Compensating errors:

A compensating error results in compensating or blacking out, either wholly or partially, the effects of other errors. Thus, while apparently there may be little or no difference between the two sides of the trial balance, giving an impression that all or most of the business transactions have been properly recorded and posted, in reality there might be a number of errors lying hidden in the books of account.

To illustrate : suppose, a credit sale of Rs.1000 to Sachin has been correctly debited to his account but in the Sales Account it has been credited as Rs.100 only, resulting in a short credit of Rs.900. Now, if this were the only error, it would be reflected by disagreement of the trial balance. But suppose, because of one or more errors in posting other transactions to the debit side of the respective accounts, there has been short debit of Rs.900 or more. Now, it the subsequent short debits cumulatively amount to Rs.900, these will match the amount of initial short credit of an equal amount such that the various errors which have contributed to it would not be disclosed by the trial balance which would show a complete agreement. On the other hand, if the subsequent short debits exceed Rs.900, the trial balance will show disagreement but like the tip of an ice-berg, the lack of agreement between its two sides will conceal far more errors than it might reveal.

1.6.7 Errors of duplication:

An error of duplication occurs when the same transaction is recorded twice in the books of original entry, and hence also posted twice in the ledger accounts. This may bee either due to failure on the part of the recording clerks to distinctly mark the invoices and other vouchers after these have been entered in the books of original entry, or because of confusion due to invoices and vouchers being received in duplicate.

Errors of this nature may be difficult to detect through the trial balance as they will not lead to any disagreement therein. Careful vouching is the only answer to detection of such errors.

How to detect errors: Strictly speaking, it is not a part of an auditor's duty to locate errors, and yet he has to do this in order to be able to report his opinion on the truth and fairness of the accounting statements. Therefore, when faced with a difference in the trial balance, the auditor should take the following steps to locate the errors responsible for it:

- Check and recheck the totals of the trial balance.
- Divide the amount of difference in the trial balance by 2(two) and see if any items on the debit equal to that sum has been wrongly entered on the credit side. It may also be that any item on the credit side equal to that sum has been wrongly posted to the debit side.
- Ascertain whether the balances of all the ledger accounts have been transferred to the trial balance.

- Ascertain on the basis of the nature of certain accounts (which always have either a debit or credit balance) whether these have been posted to the correct side of the trial balance.
- See if the totals of the various ledger accounts have been correctly made.
- Ascertain whether all the entries recorded in the original books of account have been posted to the ledger accounts, and the totals of the original books of entry have been correctly made.
- Check up the opening balances in the ledger accounts brought forward from the previous year.
- Compare the items of the trial balance with the items appearing in the trial balance of the previous year, to see if any item has been left out, and if so, why.
- Check the journal entries to ensure that the total of debits is equal to the credits.
- 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 (nine), 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, 1,000 are often due to a mistake in totaling.

1.6.8 Detection and prevention of fraud

A fraud includes any deception, cunning, or trickery with an intention to deceive or cheat another. It refers to the use of all those means which human ingenuity may devise to gain an advantage by intentional distortion of truth.

The essential elements of a fraud are as follows:

(a) There is false material representation

(b) The representation has been made with the fore – knowledge of its falsity or without any knowledge of its truth.

(c) The representation is intended to be acted upon by the persons to whom it has been made.

(d) The persons concerned have relied and acted on the basis of the representation.

(e) The persons concerned have suffered a loss as a result of so relying and acting.

Types of fraud: According to SAP - 4, "Fraud and Error," fraud may be committed in any of the following ways:

- Misappropriation or embezzlement of cash. Misappropriation of cash means wrongful conversion or fraudulent application of cash. Embezzlement means any fraudulent appropriation of another's property by any person to whom it has been entrusted or into whose hands it has lawfully come.

Misappropriation or embezzlement of cash may be committed in any of the following ways:

- Non – recording of cash sales.
- Making false entries in the accounts of customers as regards bad debts, discount, rebate, etc.
- Entering the cash received from one customer against another.
- Showing payment against purchase never made.
- Non-recording of credit notes for purchase returns.
- Non-recording of bills of exchange discounted.
- Non-recording of cash received against unusual sales, e.g., sale of furniture, junk, substandard goods, etc.
- Non-recording of unusual money receipts such as donations.
- Recording payments which are never made.

To detect fraud by way of misappropriation or embezzlement of cash, the auditor should carefully compare the entries in the Cash Book with those in the Rough Cash Book, counterfoils in the Money Receipts Book, and original evidence in the form of vouchers, invoices, salary register, wages sheet, etc.,

Misappropriation of goods: Misappropriation of goods may be committed by recording purchases of larger quantities than are actually supplied, and by appropriating the balance quantity in each case for unlawful personal gain.

Fraud by way of misappropriation of goods is easier to commit in case of goods, which, though high-priced, are not bulky and, therefore, easy to carry secretly without any fear of detection. Fraud of this nature can be detected by proper maintenance of accounts as to purchases and sales, regular stock – taking, strict check on incoming and outgoing goods, and periodic comparison between the percentages of gross profit to sales in respect of different periods.

Fraudulent manipulation or falsification of accounts: Fraud by means of manipulation and falsification of accounts and financial statements may be said to be committed when a person – (a) makes or causes a false entry in the business records: (b) alters, erases, removes or destroys a true entry in the business records in violation of his duty as imposed by law or by the nature of his position: or (d) prevents the making of a true entry or causes the omission thereof.

Generally, fraud by manipulation or falsification of accounts is committed or induced by persons holding high positions in the business set-up. It is done to overstate or understate the profits and financial position of the business so as to serve their ends. For example, overstatement of profits may be made with a view to push up the prices of own shares and securities in the stock exchange, impress the shareholders, avail easy terms from creditors, and attract prospective investors. As against this, understatement of profits may be done

to avoid tax liability, keep out the competitors and induce a fall in share prices with a view to buying the shares in bulk.

Overstatement of profits may be done by way of – (a) providing lower or no depreciation on the business assets: (b) over – valuation of assets or under – valuation of liabilities; (c) showing revenue expenditure as capital; (d) omitting items of expenditure: and (e) accounting past or future years income in the current years expenditure.

Window dressing: It means the practice of arranging the disposition of assets and liabilities in such a way that affairs of the business as shown in a subsequent Balance sheet do not truly represent the normal financial position of the business.

Window –dressing may be done in any of the following ways:

(a) Recording of sales and income of the following year in the current year.

(b) Recording of goods sent on" sale or return" basis as regular sales.

(c) Entering loans given to directors and other managerial persons as repaid at the end of the year, and then showing the same as having been advanced to the same personnel.

(d) Treatment of normal revenue expenditure as deferred revenue expenditure.

(e) Provision of less depreciation on assets.

1.6.9 Auditors position as regards fraud and errors

The primary object of an audit is to render an opinion as to the truth and fairness of presentation in financial statements about the state of affairs and results of operations of the enterprise under audit. It is not, as is commonly believed, to search for fraud and error.

SAP-4, "Fraud and Error", issued by the Institute of Chartered Accountants of India makes the following points as to the auditor's responsibility for detection of material misstatements in the financial statements due to fraud and error:

Prevention and detection of fraud and error is the responsibility of management. The management should therefore implement and continuously operate an adequate system of internal control, though this can only reduce, and not eliminate, the possibility of fraud and error.

Audit examination should be so planned that there is reasonable expectation of detection of material misstatements in financial information resulting from fraud and error.

An audit suffers from certain inherent limitations. Sample checking of transactions may exclude areas and transactions affected by fraud and error. Audit evidence in many cases may not be conclusive. Moreover, misstatements resulting from fraud are more difficult to discover that those resulting from error because of clever planning and devious concealment. Planning and performance of audit should therefore proceed on the assumption that there may be events and conditions raising a doubt as to existence of fraud and error.

The risk of fraud and error is increased by factors, such as (a) weakness in the design of the internal control system and non - compliance with identified control procedures; (b) doubts regarding the integrity and competence of management; (c) unusual internal pressures, such as paucity of working capital or earning, need of a rising profit trend, etc; (d) unusual transactions at the year-end; and (e) problems in obtaining sufficient appropriate evidence due to lack of records, documentation, etc.

The auditor can avoid responsibility for any subsequent discovery of material misstatement resulting from fraud and error in the following circumstances:

(a) He should adhere to the basic principles of audit, namely, performance of audit work with requisite skills and competence, proper documentation of important matters, and adoption of suitable procedures consistent with the results of examinations of the working of the internal control system.

(b) If he believes that a suspected fraud or error could materially affect the financial information, he should modify the existing procedure, or introduce a new one keeping in view the type of fraud or error, relative risk of its occurrence, and likelihood in the financial statements, or that the error is corrected.

However, it would be wrong to conclude that the auditor is altogether free from liability as to fraud and errors in the books of account or the financial statements of the enterprise under audit. It should be remembered that he is a professionally competent person and, in that capacity, owes a duty of reasonable care and skill in the conduct of his examination. As held in State Street Trust Co. v.Ernst (15 N.E. 2 d 41), "In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a specie of fraud upon every man who employs him in reliance on his public profession. "In Hedly Bryne & Co. v.Heller and Partners Ltd. (1964) 1 Comp. L.J.14), it was held that "a person exercising any profession or calling will be liable for negligence resulting in failure to exercise due care and skill, to any person relying upon his careless advice or information, despite the absence of contractual relationship with him."

Duty of reasonable care requires the auditor – (a) to make an intensive check of the system of internal control and check and device his audit and testing procedures accordingly; (b) to make all verifications personally or through an experienced representative; (c) to ensure that the financial statements fully conform to the generally accepted accounting procedures and relevant legal requirements; and (d) in case the financial statements disclose situation even remotely hinting at a fraud, to pursue the lead to its logical conclusion.

In Foments Ltd. v.Selsdon Ltd., (1958) I.A.R. II(H.L), it was held that "an auditor is not to be written off as a professional adder – upper and subtracter. His vital task is to take care to see that error are not made, be they errors of computation, or errors of omission or

commission, or downright untruths. To perform this task properly, he must come to it with an inquiring mind, not suspicious of dishonesty but nevertheless suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there is none. "The judgment in Kingston Cotton Mills, comparing the auditor to a watch-dog and not a bloodhound, does not absolve the auditor of his responsibility to conduct a careful checking of business transaction. In fact, his responsibility in this regard also extends to areas in which he has no adequate competence, such as valuation of assets or legal matters, in the case of which he may take the assistance of experts who will be regarded as his agents for the purpose.

1.7 CLASSIFICATION OF AUDIT

An audit is essentially a review function. The audit conducted by a professionally competent person, who is independent of the enterprise, is concerned with reviewing whether the business events have been measured and communicated through financial statements in accordance with the generally accepted principles of accounting, and as per legal requirements as applicable. In addition to audit by an independent external agency, an enterprise may also employ especially qualified persons to carry out an internal audit which has an added responsibility or reviewing the adequacy, effectiveness and reliability of the management information systems and operating control procedures.

Sometimes, the review by means of audit examination may have a limited coverage concentrating on one or more specific aspects of the business such as cost audit, operational audit, management performance audit, etc.

An audit examination may be performed in many ways, depending on the needs and convenience of the enterprise. Thus, it may be once in a year after the financial statements have been prepared, or continuously round the year at regular or irregular intervals.

Accordingly, an audit may be classified as follows:

1.7.1 General and specific audit

An audit examination may be general specific. A general audit covers all areas of the business. A general audit may be further classified as –

- Independent audit
- Internal audit
- Government audit

A specific audit is an emphasis –based audit, having reference to a particular area, object or period. It may be further classified as:

- Interim audit
- Occasional audit
- Partial audit
- Standard audit
- Audit in depth
- Post-and-vouch audit
- Operational audit
- Performance audit
- Cost audit
- Management audit

1.7.2 Continuous / periodical / balance sheet audit

On the basis of the method of examination, audit may be classified as :

- Continuous audit
- Periodical / Annual / Final / Completed audit
- Balance Sheet audit

Types of General Audit

The three main branches of audit are – (1) Independent audit; (2) Internal audit, and (3) Government audit. In many respects they are similar in nature. Yet, each branch is separate and district form the other in respect of its scope and approach, as also the responsibility of the auditor concerned.

1. INDEPENDENT AUDIT

An independent audit is conducted by a professionally qualified and competent person who is dependent of the enterprise which is hiring his services for the purpose. In India, for example, the Companies Act 1956, Lays down that only practicing chartered accountants, or persons holding a certificate under the Restricted Auditors ' Certificate Rules 1956, can be appointed as auditors of a company. The Act also lays down provisions to ensure the auditor's independence vis-a-vis the enterprise under audit.

The object of an independent auditor's examination of the financial statements is to render his opinion as to the truth and fairness with which these statements present what they purport to present, as also that these are in conformity with the generally accepted principles of accounting and legal requirements as applicable. The financial statements contain representations or assertions of the management as regards the results of

operations (profit/loss) and the financial condition of the enterprise. The auditor's opinion as regards the truth and fairness of the assertions imparts credibility to the financial statements in the eyes of those for whom these statements are meant e.g., owners, creditors, investors, governmental agencies, and so on.

Apart from his professional qualifications and competence to conduct an audit examination, the main reason why the auditor's opinion carries weight with all manner of people is his independent status. Without independence from the client-enterprise, he may not have an objective and impartial state of mind while doing his job and his opinion will be suspect. That is why auditor's independence is the focal point in the code of professional ethics and the legal provisions.

Independence does not imply a hostile attitude towards the client – enterprise or an in-built suspicion as to the data and information under examination. It only means that the auditor must function in a fair and impartial manner, not only vis-à-vis the management / owners and all those directly involved and having an interest in the enterprise, but also towards those who may be prospective shareholders and investors.

In fact, the basic difference between privately –employed accountants and the professionals who are engaged in public practice of accountancy, is in respect of their responsibility, both legal and ethical, to the enterprise under audit and to interested third parties. The need for independence on the part of a company auditor has also found recognition in the Company Law which lays down that a person shall not be qualified to be an auditor to be an auditor of a company if he has any interest whatever, financial or otherwise, in the company or its management.

BRANCHES OF GENERAL AUDIT

Independent		Internal	Government
Statutory	Private		
1. Companies	1. Sole Proprietorship		
2. Trusts	2. Partnership Firms		
3. Co-operative Societies	3. Clubs, etc.		
4. Societies registered under Societies Registration Act			
5. Electricity Supply Companies			
6. Statutory Corporations			

Types of independent audit

On the basis organizational structure of the enterprise under audit, independent audit may be classified as:

- Statutory audit, and
- Private audit

Statutory Audit:

Where audit in the case of an enterprise is made compulsory by law, it is called statutory audit. Statutory audit has been prescribed in the case of the following:

- Companies governed by the Companies Act, 1956.
- Banking companies governed by the Banking Regulation Act, 1949.
- Electricity supply companies governed by the Electricity Supply Act, 1948.
- Co-operative societies registered under the Co-operative Societies Acts.
- Public and charitable trusts registered under Religious and other Endowment Acts.
- Societies registered under the societies Registration Act, 1860.
- Corporations set up under an Act of Parliament or State Legislatures, such as the Life Insurance Corporation of India.

Important features: Certain features of the statutory audit may be notes. First, where an independent audit has been prescribed by law, the shareholders/owners of the enterprise concerned cannot make it optional even by their unanimous vote. They also cannot restrict the scope of such audit.

Secondly, statutory audit is conducted by a person properly qualified and competent under the law applicable to the enterprise. In India, for example, only a chartered accountant holding a certificate of public practice of accountancy can be an independent auditor. For carrying out cost audit, he must be a cost and works accountant within the meaning of the legislation governing him. Moreover, he must not suffer from any of the disqualifications laid down in the law to preserve and protect his independence.

Thirdly, the rights, duties and liabilities of an independent auditor are governed by law. They cannot be curtailed by the shareholders/owners of the enterprise.

Fourthly, an independent auditor is, to all intents and purpose, a representative of the shareholders / owners and it not to subserve the interests of the management of the enterprise.

Lastly, a statutory audit cannot be partial or incomplete in any respect.

Advantages: Compulsory independent audit is of great value to the persons and agencies associated with the enterprise. In the case of a joint stock company, for example, it is impossible for shareholders to verify the representations made by the management in the financial statements. They can only depend on the auditor for his expert opinion as to management claims regarding the results of business operations and financial condition of the enterprise. Audit by a competent person is also beneficial for the creditors, bankers, government departments, etc. concerned with company.

In the case of trusts, a compulsory independent audit is necessary to protect the interests of the beneficiaries against possible fraud by the trustees. An audit also safeguards the interests of the trustees who may not possess adequate knowledge of the trust laws or the principles of book – keeping and accounting.

In the case of co-operative societies, or the societies registered under the Societies Registration Act, a compulsory independent audit serves the triple purpose of – (a) providing a check against fraud by the managing committee; (b) helping in the proper maintenance of books and accounts; and (c) shielding the members of the managing committee against uninformed and baseless criticism.

In the case of business units in the public sector a compulsory independent audit is necessary to safeguard the interests of the public against defalcations and scams.

Private Audit:

Where audit in the case of an enterprise is not compulsory by law, though it is opted for by the enterprise in view of the several benefits resulting from it, it is called private audit. In India, for example, sole proprietary concerns, partnership firms, joint Hindu family businesses, etc., are not obliged under the law to get their financial statements audited. However, according to the Income-tax Act, tax audit by a professional auditor has been made compulsory in the case of all businesses whose turnover exceeds Rs.40 lacs and all professional persons whose gross receipts exceed Rs.10 lacs.

Important features: In the case of a private audit, the nature and scope of the audit is determined by the client. The auditor is required to conduct his examination within the limits determined by the client. Therefore, it becomes necessary for him to ensure that the scope of the work to be done by him is defined with absolute clarity and precision. This would serve as good defense against any subsequent charge of negligence on his part in conducting the audit examination.

Sometime, an auditor may be appointed only to prepare accounts and not to audit them. In such a case, he cannot subsequently be held guilty for failure to detect fraud or errors. In Apfel v.Annan Dester & Co., the appointment of the auditors was only for the purpose of preparation of accounts and their certificate also clearly stated, “Prepared from the books of Mrs.Apfel and in accordance therewith”. In the light to this, the Court did not accept Mrs.Apfel’s charge of negligence against the auditors for failure to detect fraud committed by the sons.

But in State Steel Trust Co, v.Ernst, where the auditors were appointed to perform a full audit and the client raised a loan on the basis of audited accounts, it was held that the auditors owed duty of reasonable care and skill not only to the client but also to the third parties who relied on his report.

Advantages: The following are the main advantages of a private audit:

- Audit by a professional auditor serves as an assurance to the owners that the accounts of business transactions are being properly maintained, and the there are no fraud and errors by employees of the enterprise.
- Audited statements and accounts make a reliable basis for assessment of tax liability under various laws, such as income-tax, wealth-tax, sales-tax, etc., as the tax authorities readily believe them.
- Audited statements and accounts of a business provide a reliable index to its profitability and financial soundness in case of its purchase or sale as a going concern.
- Audited statements and accounts are valuable in settlement of claims and disputes between partners.
- Audited statements and accounts facilitate the process of raising loans and advances from financiers.

Internal Audit

Internal audit may be defined as a exercise in managerial control by means of an independent appraisal by employees of the organization itself.

Scope and objects: The scope and objects of internal audit may be stated as follows:

(a) to study and evaluate the adequacy and effectiveness of accounting, financial and operating controls;

(b) to ascertain the degree of compliance with pre-determined policies, plans and procedures;

(c) to ascertain the extent to which business assets are accounted for and safeguarded from losses;

(d) to ascertain the authenticity of accounting and other data compiled within the organization;

(e) to evaluate the quality of performance in carrying out assigned responsibilities; and

(f) to furnish the members of management with objective analysis, comments and recommendations as regards activities of the business so as to help them in efficient and effective discharge of their responsibilities.

With the introduction of the Manufacturing and Other Companies (Auditor's Report) Order, 1988, which has elevated financial audit to the level of "social audit" establishment of an effective internal audit system, has been made obligatory in the case of every specified company. Accordingly, in the case of every company having a paid-up capital exceeding Rs.25 lakes, or an average annual turnover exceeding Rs.2 crore for three years immediately preceding the financial year concerned, the statutory auditor is required to state whether the internal audit system in commensurate with the size and nature of the business of the company.

Internal audit differs from an external audit in both its scope and objects. No doubt, an internal auditor, like the external auditor, is concerned with investigation of the truth and fairness of representations. But the representations with which he is concerned cover a much wider ground and, in many cases, the relationship of such representations with the accounts is also not so direct. Moreover, being an employee of the enterprise, the internal auditor has greater interest in the operations of the business, and is therefore keenly interested in making them more efficient and profitable.

Nature of work: Internal auditing may be called as a special segment of the broad field of accounting. The techniques and methods of an internal auditor is to ensure that there is proper compliance with (a) policies, rules and procedures of the enterprise; (b) good business practices; (c) generally accepted accounting principles; (d) laws of the land; and (e) government regulations.

Authority and responsibility: Internal auditing is a staff function. As such an internal auditor does not exercise direct authority over other persons in the enterprise whose work he reviews and appraises. Moreover, since independence is essential to the effectiveness of internal auditing programme, he is generally made answerable to a high ranking official so that the scope of his activities is broadened and his findings and recommendations are duly considered with that an external auditor who is responsible to the proprietors (shareholders) and interested third parties. Still, the fact of his being a salaried employee of the enterprise does not by itself limit or change the standards of integrity or professional conduct which he is required to apply to his work.

Governmental Audit

Governmental audit may be broadly classified as – (a) audit of government departments; (d) audit of statutory corporations; and (c) audit of government companies.

Audit of government departments: Provisions as to audit of Government departments and undertakings not registered as companies, are contained in Art. 149 of the Constitution as follows: “The Comptroller and Auditor-General Shall perform such duties and exercise such powers in relation to the accounts of the Union and of the States and of any other authority or body as may be prescribed by or under any law and by Parliament.”

Audit control by the Comptroller and Auditor – General extends to all departments of the Union and the States as also any other authority or body. An authority means a legal body vested with some power and includes an undertaking set up by special Act of the Legislature. The duties and powers or the Comptroller and Auditor-General have been specified under the Comptroller and Auditor General (Duties, Powers and Conditions of Service) Act, 1971.

Distinction between External and Internal Audit

Points of Distinction	External Audit	Internal Audit
1. Status of auditor and remuneration	Wholly independent of the enterprise. Engaged for fees only, for his professional services.	An employees of the enterprise working for a salary.
2. Scope	Scope of work is determined by the responsibilities cast on the auditor by the statute or contract.	Scope of work is determined by the management, but it generally includes review
3. Approach	Main concern of the external Auditor is to collect adequate and reliable evidence to support his opinion as to the truth and fairness of the representations made in the financial statements.	Main concern in to ensure compliance with (a) policies, rules and procedures of the enterprise;(b) good business practices; (c) generally Accepted accounting principles; and (d) legal and governmental regulations, and to report any violations to the management.
4. Responsibility	Directly responsible to the owners, though in some cases his responsibility also extends to interested third parties.	Responsible to the management He has no responsibility or freedom to report to outsiders.

According to Art; 150, the Comptroller and Auditor-General may, besides exercising audit control, also prescribe the form in which the Union and the States have to maintain their accounts.

According to Art, 151, the reports of the Comptroller and Auditor-General relating to the accounts of the Union, shall be submitted to the President, who shall cause them to be laid before each House of Parliament. The reports relating to the accounts of the States are to be submitted to the Governors of the respective States who shall cause these to be laid before the State Legislature.

Audit of statutory corporation: A statutory corporation is set up under a special Act of the Legislature. In most cases, the Act itself requires the Comptroller and Auditor –

General to audit the accounts of the corporation, though in some cases provision has been made for audit of accounts by professional chartered accountants. In the case of Life Insurance Corporation, Central and the State Warehousing Corporations, for example, accounts are audited by professional chartered accountants.

Accordingly, auditors for the State Bank of India and the Industrial Development Bank are appointed by the Reserve Bank of India. In case of the Industrial Finance Corporation, one auditor is appointed by the Industrial Development Bank while the other is appointed by the shareholders. The Food Corporation appoints its auditor on the advice of the Comptroller and Auditor General from a panel approved by the Central Government. As for the Life Insurance Corporation, it appoints its auditor with the previous approval of the Central Government.

The powers of auditors are also defined in the Acts under which the corporations are brought into existence.

Audit of government companies: According to Sec.617 of the Companies Act, a Government company is one in which at least 51% of the paid-up share capital is held-(a) by the Central Government; or (b) by one or more State Governments; or (c) by the Central or State Governments along with one or more Government companies or corporations owned or controlled by the Central Government. A subsidiary of a Government company shall also be deemed to be a Government company.

Sec, 619 of the Companies Act dealing with appointment, etc., of auditors for a Government Company has in certain respects an over-riding effect vis-à-vis Secs.224 to 233 which deal with appointment, etc., of company auditors. According to it, auditor of a Government company is to be appointed by the Company Law Board on the advice of the Comptroller and Auditor – General of India, who has also been vested with the power to direct the manner in which the accounts of the company are to be audited. The latest directions issued by the Comptroller and Auditor – General make the audit of Government companies still more comprehensive, than mere verification of financial statements. These cover a wide field, i.e., systems of accounting, internal control, maintenance of Production and Manufacturing Accounts, Cost Accounts, Profit and Loss Accounts, Balance Sheet and their general review, townships, manpower, service units, and analysis of accounts to indicate capital formation, growth and funds-flow of the company.

The Comptroller and Auditor –General may also conduct supplementary or test audit of the accounts of a Government company by a person authorized in this behalf.

The auditor of Government company shall submit a copy of his audit report to the Comptroller and Auditor –general, who shall have the right to comment upon, or supplement the audit report in such manner as he may think fit. The comments, etc., of the Comptroller and Auditor – General shall also be placed before the Annual General Meeting of the company along with the main audit report.

Specific Audits

A specific audit is one which is restricted in its scope sin terms of areas, events, or period to be covered. In each case, its object is limited such as ascertainment of profits from the point of view of declaration of interim dividend, detection of a suspected fraud, close examination of certain aspects of business, and so on.

Interim Audit

An interim audit is conducted in between two annual audits. Its object is to enable the company to declare an interim dividend. It involves a complete examinations and review of the accounts and records of the business up to the date of the interim audit. Thus, interim audit may be ordered for a quarter, or six months.

Advantages

- It helps in quick detection and rectification of errors and fraud.
- It facilitates early completion of the annual audit.
- It is helpful in the case of business where interim figures have to be published.
- It exercises and effective moral check on the staff of the enterprise.

Disadvantages

- Figures audited up to the date of an interim audit may subsequently by alter or tampered with.
- The staff conducting an interim audit has to make extensive notes as to the figures in the books of account. This causes an unnecessary increase in their work.
- Interim audit may prove expensive, because it involves additional work on the part of the auditor.

Occasional Audit

An occasional audit is meant for special event, time or purpose, etc. It is not conducted on a regular basis. It may be conducted to discover any suspected fraud or errors. It may be ordered also when an incoming partner or prospective investor or the Government requires it. An occasional audit is mainly held in the case of business concerns where audit is optional, e.g., sole proprietary and partnership firms. In the case of companies, trusts etc., the annual audit is a regular feature under legal compulsion.

Partial Audit

A partial audit is limited in scope. Thus, when an audit is carried out in respect of only a part of the books of account, or records of a part of the year, it is called a partial audit.

If an auditor is asked to check all the books of account expect the payments side of the cash book, because the proprietor himself is in charge of making payments by cheques and therefore he sees no possibility of an error or fraud misappropriation of goods, the auditor may be asked only to check the records and books pertaining to the purchase and sale of

goods. Partial audit has no place in the case of a business establishment where audit is legally compulsory and the scope of audit cannot be curtailed at the desire of the management of the enterprise.

The report of the auditor conducting partial audit must clearly state the curtailed scope of his work so as to avoid liability for any error or fraud existing in the books and records not examined by him.

Standard Audit or Sample –Checking

Standard audit is in fact audit examination by audit testing. It has been defined as "a complete check and analysis of certain items and, contingent upon effective, check, an appropriate test check on remaining items, the whole of the unqualified opinion." In a standard audit, there is a detailed checking and analysis items. The decision as to the items to be subjected to a detailed analysis or merely sample-checking will depend on the effectiveness of the internal control system operating within the enterprise.

Audit –In-Depth

Audit-in-depth is a technique of examination belonging to the family of sample-checking, with only this difference that under an in-depth audit, a selected number of transactions are subjected to a detailed, step-by-step verification.

In the case of audit-in depth of a purchase invoice, for example, the auditor focuses his examination on all the stages through which a purchase transaction passes and the documents it gives rise to, in the course of its journey. Thus, he examines the requisition slip, clearance note by the authorizing official, tenders submitted by suppliers, purchase order, goods received note, goods inspection note, and entries in the bin-card and stores ledger.
When conducted along side test-checking, audit-in-depth provides the auditor with an over-all picture of the procedure being followed.

Post –And-Vouch Audit

A post-and-vouch audit is audit examination by detailed verification of individual transactions. Under it, each and every transaction of a business is examined from the point of its appearance in the books of original entry till it has been posted. For this purpose, the auditor uses distinctive ticks or signs in different colors for each aspect of examinations, i.e., totaling, posting, balancing, carry forwards, and so on. However, post-and-vouch audit is no longer conducted in case of large-sized enterprises where there is a vast increase both in number of complex business transactions, and therefore an effective system of internal control is operated, or where the enterprise has adopted a mechanized system of accounting.

Operational Audit

Operational audit is similar to internal audit but its scope extends to operational (administrative) areas. Operational audit is not a distinct and separate type of audit characterized by special programmes or techniques. It is rather a manner by which the internal auditor approaches his assignment, analyses the subject of his review and regards the results. In this sense, it is essentially a frame of mind, and a method of approach with which the auditor views his work.

While financial auditing is primarily concerned with the verification of financial statements, operational audit deals with operating (administrative) controls and is equally at home in financial and non-financial areas. No doubt, it uses and analysis historical data, but only with a view to finding ways of improving future business operations.

In the words of Fredic E.Mints, an operations audit should aim at making "an appraisal of the way in which a particular operation or activity is administered; whether its objectives have been clearly defined in conformance with sound business principles and communicated to all concerned; whether the policies under which it operates conform to the established objectives; whether those policies are implemented b7y specific procedures and whether these procedures are followed as intended; whether necessary administrative information is accumulated by orderly methods; and whether management is provided with adequate, timely and accurate reports containing information on matters of primary concern."

Performance Audit

A performance audit is mainly concerned with ascertaining whether the various internal activities in the enterprise are being carried out efficiently. In this sense, the functions of a performance audit are by and large the same as that of internal audit.

In order to ensure effective internal control, many persons within the enterprise have to perform various control activities. For example, for a proper control over cash disbursements, all activities forming part of the purchase procedure have to be closely reviewed, such as, departmental requisitions, purchase orders, purchase invoices, goods received memos, and so on. A review of activities performed at each of these stages will be an appropriate performance audit.

Cost Audit

A cost audit may be defined as the "verification of the correctness of cost accounts and of the adherence to the cost accounting plan." According to Simith and Day, cost audit means "the detailed checking of the costing system, techniques and accounts to verify their correctness and to ensure adherence to the objective of cost accounting."

Financial audit v. Cost audit: Both cost and financial audit are concerned with the financial aspect of each and every business transaction. However, the difference between

the two lies in the fact that while cost audit concentrates on the items which go to make the cost of the goods produced, financial audit aims at reviewing all the items appearing in the financial statements, including those forming part of the cost structure. Moreover, while financial audit is compulsory by law in the case of all kinds of companies, trusts, etc., cost audit is compulsory only in the case of companies carrying on business as specified in the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

The other points of distinction between the two are:

(a) The auditor conducting financial audit pronounces his opinion as to the truth and fairness of the assertions in financial statements. The cost auditor is mainly concerned with the propriety and efficiency of transactions having a bearing on the cost composition of the goods produced.

(b) Cost audit is generally in the interest of customers, shareholders and the society at large while financial audit mainly benefits the shareholders.

(c) Financial audit aims at examining whether profits of the period under review have been truly and fairly arrived at, and in this sense it is a mere postmortem of the past records, while in a cost audit the past records provide a basis for assessing the business potential for earning greater profits in future.

(d) In financial audit the report of the auditor is submitted to the management of the enterprise while the cost auditor reports to the Company Law Board and the management of the enterprise.

Management Audit

According to LeslieR.Howard, management audit is "an investigation of a business from the highest level downward in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with the outside world and the most efficient organization and smooth running of internal organization.

The objects of management audit are to pinpoint weaknesses or irregularities at whichever level of management these may exist, so as to attain maximum efficiency and effectiveness in every field, and to aid and assist the management in the accomplishment of this objective.

Financial audit v. Management audit: Management audit is different from financial (in some cases statutory) audit in several material respects. First, while financial audit aims at examining the past records with a view to ascertaining the truth and fairness of the representations made in the financial statements, management audit is concerned with a review of the past performance so as to ascertain whether it is in tune with the pre-determined objectives, policies and plans, and to suggest measures to remedy the deficiencies and lacunae, including modification or even alteration of the objectives, policies, etc., in order to relate them to resource availability.

Secondly, while the financial auditor reviews the past records to test the validity of the representations made in the financial statements, he does not concern himself with whether the management had been efficient and effective enough to attain the pre determined targets. The management auditor, on the other hand, reviews not only the past performance but also pinpoints the causes of inefficient performance and suggests suitable steps to correct the same.

Lastly, the scope of management audit is far wider, in the sense that it encompasses each and every aspect of business including a review of objectives, policies, organization structure, production planning and control, efficiency of the personnel, and so on. As against this, financial audit concentrates only on the financial aspects of the business.

Continuous / Periodical or Annual Audit:

Depending on the needs, convenience and cost – bearing capacity of the enterprise seeking an audit, the audit examination may be done continuously round the year at regular or irregular intervals, or only once in the year after the financial statements have been prepared.

Continuous Audit:

According to Spicer and Pegler, "a continuous audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year and performs an interim audit; such audits are adopted where the work involved in considerable and have any points in their favor although they are subject to certain disadvantages."

In a continuous audit, the auditor and his staff is constantly engaged in checking the accounts during the whole period, or where the auditor and his staff attend the client's offices at regular or irregular intervals during the period.

Applicability

Continuous audit is suitable in cases where the final accounts are desired to be presented soon after the close of the financial year as in the case of a bank, or in the case of a business where the number of transactions is very large, or where the system of internal check is not satisfactory, or where the management insists on statement of accounts to be presented to it after the end of every month or quarter.

Advantages

- Early discovery of errors and fraud. In a continuous audit, the auditor checks theaccounts, in detailed manner at regular intervals. It is thus possible for him to detect errors and fraud, easily and quickly. If the accounts are audited after the end of the year, it will be difficult to locate an error or fraud from a labyrinth of details, and the loss resulting to the business from the undetected errors or fraud may be sizable.

- Close and extensive checking. As the auditor visits the client's office at regularintervals, the number of transactions to be checked at each visit will be relatively small. This will enable the auditor to examine each transaction closely and extensively. If the audit is to be undertaken after the end of the year, such detailed checking will be difficult, if not impossible.

- Familiarity with technical details. The auditor is in regular contact with theclient's business. This enables him to be familiar with all the aspects of the business. As a result, he is able to make useful suggestions to the client as to improvement or operational functioning.

- Quick presentation of accounts. The accounts are checked round the year so that it becomes possible for the final audited accounts to be presented to the shareholders immediately after the end of the financial year. If the accounts are to be checked after the expiry of the financial year, there is bound to be delay in the presentation of accounts as the auditor will be required to examine all the accounts at one go.

- Enforced regularity at client's end. Frequent visits by the auditor to the client's office makes the client's staff regular. The accounts are maintained up-to-date and accurate for fear that the auditor may land up in the office any time and ask for accounts to be balanced there and then.

- Moral check. In the course of his work, the auditor may also pay surprise visits to the client's office. This will mean a great moral check on the staff of the client and they will have to regularly update their books to avoid embarrassment.

- Relief to auditor. The several visits by the auditor to the client's office enable his work to proceed smoothly. It also boosts his confidence in his capacity to handle his work with efficiency and effectiveness.

- Declaration of interim dividend. If the management desires to declare interim dividend, it can easily do so because properly audited accounts are available to give an idea as to the profits actually earned till the date of the declaration.

Disadvantages

- Tampering with figures. In a continuous audit, the auditor picks up the threads of his examination of accounts from where he had left them at his previous visit. He does not again go through the entries which he had examined during his last visit. This may tempt a dishonest clerk to tamper with the figures examined by the auditor during the previous visit in order to commit or hide a fraud.

- Interruption of client's work. The auditor visits the client's office at regular or irregular intervals. This may cause dislocation in the client's work, in the sense that while first the auditor may have to wait until the books are made ready for the examination, later the staff may remain without work until the auditor has examined the books.
- Prohibitive cost. A continuous audit is an expensive audit, in that several visits by the auditor will involve payment of higher fees to him.
- Loss of link in work. It may be difficult for the auditor to remember every piece of work that he had left undone during his last visit. The loss of link in his work may be unavoidable because of interval between the two visits, but as a result of this some important queries may remain unanswered and some vital points may go unexplained.
- Spoon-feeding. Frequent visits by the auditor and his staff may cause lethargy and indifference on the part of the client's employees. They may not exert much to locate even minor discrepancies in their books, thinking that it will in any case be discovered by the auditor during his next visit.
- Likely collusion between client's staff and auditor's staff. Frequent visits by the auditor's staff may generate friendly feelings between them and the client's employees. While this may lessen the element of moral check on the client's staff, there may also be collusion between them so that errors or fraud may be deliberately ignored.
- Exhaustive and tedious work. In a continuous audit, the auditor is required to take detailed notes about the work done by him at each visit. Thus, besides being arduous, the work also causes boredom.

Safeguards against deficiencies of a continuous audit: The disadvantages of continuous audit can be easily overcome if the auditor takes the following precautions:

- The auditor should so plan his audit programme that no part of his work at any visit is left undone.
- A client's staff must be specifically instructed not to make any alternations in the figures without first bringing them to the notice of the auditor. In any case, alterations in the figures should be by way of rectification entries rather than by way of erosion or over-writing.
- Any unanswered query or unexplained point should be noted down in the audit not book so as to sort it out at the subsequent visit.
- Before commencing the work at each subsequent visit, the auditor should carefully glance over the work done at the previous visit so as to pinpoint any alteration in the figures.

- As it is relatively easy to perpetrate fraud in personal accounts by passing corresponding fictitious entries in the impersonal accounts, the auditor should leave the examination of impersonal accounts till the time of final audit.
- By a just and sensible allocation of work among the audit staff, the auditor can prevent the work becoming tedious or boring.
- To prevent collusion between audit staff and the client's employees, the auditor may rotate the work among them in such a way that no audit clerk is allowed to check an account from beginning to end.

Periodical / Annual / Final / Completed Audit:

Periodical audit is done at the close of the financial year after the books of account have been closed and the final accounts drawn. In this case, the audit is commenced and completed in a single uninterrupted session As the audit work begin after the finalization of the books of account, routine checking and other audit procedures will only begin after it. In this sense, in a periodical audit the auditor is given possession of the books of account and these are returned to the client only after the audit has been completed.

Advantages

- Smooth flow of work. There is no loss of link in the work as the entire audit is completed in a single continuous session.
- No dislocation of client's work. The work of the auditor does not cause any dislocation in the work of the client's staff because the auditor commences his work only after the year's books have been finalized.
- Economy. Periodical audit is economical and suitable particularly for small sized business units.
- Little chance of collusion. There is no possibility of friendly ties developing between the audit staff and the client's staff and as such the chances of any collusion between them are minimized.
- No loss of interest. There is less possibility in periodical audit of the work becoming mechanical or boring.

Disadvantages

- Detailed checking not possible. In a periodical audit, accounts cannot be subjected to a detailed checking because the work is to be completed in a short time.
- Non-detection of errors and fraud. For lack of detailed checking, errors and fraud may continue to remain undetected.
- Delay in presentation of final accounts. As the work of audit usually takes a long time to be completed, the presentation of final accounts in the annual general meetings is likely to be delayed.

- Unsuitability for large concerns. In large concerns where the number of transactions are voluminous and complex, periodical audit is not practicable and for this reason it is often not preferred by them.

Balance sheet audit:

In a Balance Sheet audit, the audit is concerned only with the items appearing in the Balance Sheet, such as, capital reserves, other outstanding liabilities and the assets of the business.

Balance Sheet is of recent origin. It has acquired popularity in the U.S.A. The reason for its popularity lies in the fact that even though it concentrates mainly on the items of the Balance Sheet, it does include an examination of other business operations. In any case, as the balance of the Profit and Loss Account is itself a part of the Balance – Sheet, the auditor will have necessarily to review the transactions recorded in the Profit and Loss Account. For this reason, Balance Sheet audit may be said to be similar to an annual audit.

1.8 ADVANTAGES OF AUDIT

The main advantages of audit are as follows:

1.8.1 For the enterprise:

- Employees in charge of maintenance of books of account and other records are regular, careful and systematic in their work.
- Errors and fraud, if any, committed by employees of the business are promptly detected. In any case, knowledge of an impending audit exercise a moral check of the employees who might otherwise be tempted to commit defalcation and embezzlement.
- Loans and credit can easily be obtained on the basis of audited accounts which are widely regarded as a reliable index to the state of affairs of the enterprise.
- Liability of the enterprise as to income-tax. Wealth-tax, sales-tax, etc., can easily be determined on the basis of audited accounts as these are readily believed by the tax authorities. The Income-tax Act also contains a provision for holding tax audit.
- In case a running business is proposed to be sold, purchase consideration can easily be determined on the basis of audited accounts.
- Audited statements or accounts provide a mutually satisfactory basis for the resolution of disputes as to higher wages and bonus payments to workers.
- In case of loss or damage to business property, audited accounts facilitate the determinations of claims against the insurers.

- Weaknesses of the existing system of internal check and internal control may be detected such that remedial steps can soon be initiated.
- Audit is an easy means to ascertain whether the undertaking is in fact maintaining the registers and books of account as required under the law.
- The enterprise can benefit from the professional competence and experience of the auditor who is always at hand to appraise the efficacy of various control measures, and to suggest improvements therein.

1.8.2 For owners of the enterprise:

- In a sole proprietary business, in the case of which audit is not compulsory, audited statements of accounts provide a proof that all business transaction have been duly accounted for, and there is no error or fraud.
- In a partnership firm, audited accounts serve as an evidence of proper management of the affairs of business by the active partners and employees of the firm. Such accounts are also of great help in settlement of accounts in case of admission, retirement or death of a partner.
- In a joint stock company, shareholders rely on the audited statements of accounts to satisfy themselves that the affairs of the company are being smoothly run and their investment is safe.
- In the case of trusts, co-operative societies, etc., auditing serves as an evidence for the beneficiaries' member, etc., that their interests are being properly and efficiently looked after.

1.8.3 For others:

Audited statements of accounts are also relied upon by outsiders for various purposes. In the case of banks, for example, audited statements of a business serve as reliable guide to make decisions as to loans to that business. Insurers also rely on audited statements to settle claims in respect of damage to, or loss of business assets. For determination of liability under income-tax, sales-tax, wealth tax, etc., tax authorities unquestioningly accept the audited statements.

1.9 LIMITATIONS OF AUDITING

Conceptual restriction

Auditing has traditionally been regarded as a practical subject dealing mainly with procedures and techniques of checking, ticking, totaling, vouching, etc. As a result, several vital aspects such as finances, managerial efficiency and effectiveness, business ethics, etc., are ignored as being outside it scope. In the circumstance, it can hardly be expected to do justice to its objects.

Postmortem on prepared accounts

Auditing beings where accountancy ends. The auditor may be nowhere around when the accounts are being finalized. Therefore, it may not be possible for him to discover clever manipulations in the books and accounts at the preparatory stage. Thus, many questionable facts may remain undiscovered even after the accounts have been audited.

Dependence on inside information

Books of account of a business, however complete they may be in every respect, do not tell the complete story as to transactions recorded therein. As such, an auditor has of necessity to seek additional information, clarifications and explanations from various personnel of the enterprise. Authenticity of such information, etc., is always open to question, particularly so if the personnel providing it have themselves been a party to the manipulation of books of account. As a result, even the audited statements or accounts may not reveal the correct or complete picture.

Inadequate or faulty external evidence

Though an auditor will be well within his right to tap external sources for evidence to support the propositions made in the accounting statements, such evidence may not always be wholly reliable. A debtor of the business might, for example, provide wrong information about the debt owed by him. The company lawyer might twist facts to say that there are no claims against the company. The valuer might go wrong in valuing an asset. In the circumstance, even audited accounts may lack authenticity.

Application of faulty techniques

Collection of adequate evidence in support of any proposition made in the books of account depends of the types of audit techniques employed for the purpose. Where an audit technique is not consistent with the nature or type of the business enterprise, or with the method of record-keeping followed by it, it will not provide the right kind of evidence, and even audited accounts may not tell the entire story. Such a possibility is more likely in the case of an auditor who is simultaneously engaged in audits of a number of organizations, large and small, complex simple, with different methods of record-keeping.

Formation of faulty judgment

The auditor's judgment as to correctness and fairness of the propositions in the books of account is based on an objective evaluation and critical review of the evidence collected by him through appropriate audit techniques. However, at times personal opinion of the auditor might cloud his sense of judgment so that his report might contain an assessment which is unsupported by relevant material evidence. In the event, the audited statements will not mirror the correct position of the business.

1.10 QUALIFICATION AND QUALITIES OF AUDITOR

To be an auditor, a person is required to posses' professional qualifications and also personal qualities of attainment and character.

Statutory qualifications

The auditor must be a chartered accountant within the meaning of the Chartered Accountants Act of 1949. For this, he is required to pass the examinations conducted by the Institute of Chartered Accountants. He is also required to secure a certificate to take up public practice of accountancy. A person holding a certificate under the Restricted Auditor's Certificate (Part B States) Rules 1956 is also qualified to be appointed as auditor.

Personal qualities

An auditor is required to perform a wide variety of functions, and to be able to do so, he must possess several qualities – some tangible, others not so tangible. Some of the qualities may be acquired through formal education and training, while for the others he will have to depend on his experience in the school of life.

The various qualities required of him are as follows:
Professional expertise:

- **Knowledge of accounting.** He should know the conceptual framework of accounting, various systems of accounting, and its functions in a business – oriented society. He should also keep himself abreast of the changes and developments in the field of accounting. He should be familiar with the accounting principles as regard determination of periodic income, recognition of revenue and capital items of income and expenditure, inventory valuation, depreciation, equity measurement, and content and presentation of financial statements.

He is also required to be fully conversant with the Accounting Standards (AS) issued by the Institute of Chartered Accountants of India and to ensure that the mandatory standards are followed in the preparation and presentation of financial statements of the client.

- **Knowledge of cost accounting.** He should be fairly acquainted with the concepts of cost accounting such as direct and indirect costs, cost allocation, allocation of overheads, standard costing, cost and budgetary control, etc. He should also recognize the importance of cost accounting to decision making and planning, such as, make or buy decisions, product mix, inventory control etc.

- **Knowledge of accounts of business under audit.** He should be adequately familiar with the system and techniques of accounting in the business under audit.

- **Knowledge of business laws.** He is required to possess an extensive knowledge of the laws governing partnerships, companies, trusts, agencies, factories, estates, property, etc. He should understand the relationship between Central and State laws and between the statutory and the common law. He should also know how to apply the principles of law to accounting and auditing problems.

- **Knowledge of production systems.** He should possess adequate knowledge about the nature of production, production planning and processes, and how cost accounting is related to them in the business under audit.

- **Knowledge of economics.** He should be familiar with the principles of economics effects of economic factors on business units and their interactions, relationship between demand and price, elasticity, competition, etc.

- **Knowledge of mathematics and statistics.** He should have a fair knowledge of mathematical and statistical methods of solving business problems by quantification techniques.

- **Knowledge of general management.** He should have a broad understanding of organization theory and behaviour – decision – making process, individual and group behaviour, and authority responsibility relationships.

- **Knowledge of financial management.** He should have proper understanding of the concepts and methods used in financial analysis. This would help him in evaluating the capital needs of the business under audit, and the effects of depreciation and taxes on the availability of funds.

- **Knowledge of marketing management.** He should have proper knowledge of the methods of pricing, relative merits and demerits of the various channels of distribution, and how accounting can be used to sort out marketing problems.

General qualities:

- **Honesty and integrity.** He should be honest and steadfast in his ethical behavior. He should develop the sense of keen judgment to avoid errors of omission of commission, exercise due care and skill in his work, and do nothing under pressure.

- **Tactfulness.** He should be firm, yet diplomatic, with his client and his staff. He should know "when to speak out, when to be silent, how to say or write that which is necessary but awkward, and courage to face up to the need for doing so.."

- **Vigilance.** He should be ever alert in his work. He should be able to perceive not only what has happened but also what might happen, with a sense of imagination to see beneath and beyond the surface.

- **Judgment**. Exercise of judgment is a prime factor in any audit. The auditor is constantly required to make judgment as regards evidence, audit programme and procedures, and he should be able to distinguish the relevant from the irrelevant, important points from those which are relatively unimportant.

- **Responsibility.** Public confidence in the auditing profession comes from high standards of performance and a high sense of responsibility to the public interest. In both action and behaviour, the auditor must display a great sense of responsibility.

- **Diligence.** Auditing profession is said to be a zealous mistress, making exacting demands on the auditor's time, energy and attention. The auditor is required to work diligently and methodically to accomplish his tasks as also to set an example before his subordinates.

- **Communication.** He should be able to communicate effectively, both orally and in writing. Particularly in the matter of report writing, he should be able to convey his message clearly, concisely and precisely.

- **Common sense.** The auditor must have robust common sense, without which he would be a mere technician, knowing everything about his job but lacking in ability to apply it at the right time and place.

These are the qualities and qualifications expected with an auditor.

Review Questions:

1. Define auditing. And how it is different from accounting?
2. State the general objects of Auditing?
3. Discuss the advantages and limitations of auditing.
4. Describe the Qualities of an auditor.
5. Describe the main types of errors.
6. What are the classes of the audit? Briefly discuss the merits and demerits of them.
7. Explain the evaluation of auditing.

UNIT- II

LESSON-2

INTERNAL CONTROL

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2.0 AIMS AND OBJECTIVES

In Unit 1 we discussed the fundamentals and basics of auditing. Here in this unit 2 internal Control is explained which means the overall control environment established by the management for auditing. Various methods for Internal Control and internal check are explained. With the connection of that internal audit and External audit is explained. Then Vouching, kinds of vouchers, importance of vouching, vouching of cash transactions are explained.

2.1 INTRODUCTION

Internal control is the overall control environment, established by management of an enterprise for effective and efficient monitoring and control of, its operations. It aims at adherence to management policies, safeguarding of assets of the enterprise, and proper accounting arid record of the business, transactions. Internal check and internal audit are vital components of the system of internal control.

The auditor should property understand and assess the internal control system to determine the degree of reliance to be placed on it and accordingly to plan, the nature, timing and extent of audit procedures to performed by him. If the internal control is found to be effective, the auditor may resort to selective verification. However, in cash internal control system is weak in certain areas, there will have to be detailed verification of the related transactions.

2.2 INTERNAL CONTROL

The system of internal control means a plan of organization laying down appropriate division of functional responsibilities, and a proper authorization and record of business transactions by persons who are competent to discharge their assigned duties. Internal control goes beyond the accounting functions of the organization and incorporates both accounting and administrative controls.

Accounting controls comprise "the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safe guarding of assets and the reliability of financial records." They generally include the system of authorization and approval of transactions, Separation of duties with regard to record-keeping and accounting reports from those concerned with actual business operations, custody of assets, physical control over assets and internal audit.

Administrative controls, on the other land, comprise "the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies; and usually relate only indirectly to the financial records." These include statistical analysis, time and motion studies, performance reports, employee training programmers, and quality controls.

2.2.1 Objectives of internal control relating to accounting system

According to SAP-6, issued by the Institute of Chartered Accountants of India, internal controls relating to the accounting system are meant to accomplish the following objectives:

- To ensure that transactions are executed in accordance with management's general or specific authorization.
- To ensure that all transactions are promptly recorded in the correct amount in the appropriate accounts and in the accounting period in which these are executed so as to permit .preparation of financial information within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets.
- To ensure that assets are safeguarded from unauthorized access, use or disposition.
- To ensure that the recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any difference.

2.2.2 Characteristics of an effective internal control system:

A system of effective internal control is distinguished by the following characteristics:

1. A plan of organization, providing for appropriate division of functional responsibilities.
2. A system of authorization and record procedures, adequate to provide reasonable accounting control over assets, liabilities, revenue and expenses.
3. Sound practices in the performance of duties and functions of each of the organizational departments.
4. Personnel of a quality which' is commensunite with their, responsibilities.

- **Plan of Organization:** For any system of internal control, an appropriate plan and structure of the organization is essential. . Division of functional responsibilities in the organization will naturally differ on the basis of nature of the' business, operational methods, size, number of departments, divisions, and so on. But the organizational structure should provide for adequate independence for the various functions performed at different levels. Preferably, the division of duties should be such that activities of a department are controlled by records maintained by another department. Similarly, while custody of various assets should be the responsibility of one department, maintenance of accounts relating to those assets 'and recording of transaction connected with them, should be under the charge of another department.

- **Authorization, record and, control procedures:** The basic objective of authorization record and control procedures should be ensure that- (a) every item of expenditure has been properly authorized and accounted for; (b) every item of receipt has in fact been received and duly accounted for; and (c) there is proper custody of the funds and other assets of the enterprise, and there is no misapplication, or misuse of the same.

  This will call for establishment of suitable procedures for proper review and authorization of all transactions before they are entered in the books of account. Documents pertaining to each transaction should bear signatures or initials of the persons concerned, to ensure effective accountability. Pinpointing of responsibility for the transaction will become easier if there is an accounting manual laying down the authority and responsibility of all persons connected with the accounting work.

- **Sound practices.** Along with proper procedures, there should also be inherent safeguards in the system of internal control. These should be in the form of an effective system of internal check lying down that no single person should alone handle a transaction completely "from beginning to end. If there is an in-built arrangement in the accounting system to the effect that work of every person will, in the ordinary course, be checked by another person in the same or another department, clerical errors will be minimized, the accounting system Will acquire reliability and errors and fraud will be easily detected.

- **Quality of personnel**. The need for competent personnel for proper functioning of the internal system is paramount, as only then the prescribed procedures can be carried out in an efficient manner.

  Competency of personnel does not mean competency of departmental heads and key personnel alone, but all the persons who perform routine tasks at different levels. This will require proper selection and training of the personnel, backed by effective direction, supervision and control and an ample provision for quick corrective action to prevent lax performance, or violation of prescribed procedures.

2.2.3 Inherent Limitations of Internal Control

According to SAP-6 Internal controls can only provide reasonable assurance as to the accomplishment of their objectives. They cannot absolutely· effective in this task because of limitations which are inherent to any system of internal· control. These limitations are as follows:

- Operation of an internal control system involves expenditure of both time and money. Management's concern with matching the costs with benefits of the system may have the effect of weakening the controls.
- Ordinarily, internal controls are concerned more with transactions of a routine nature than unusual transactions which may call for greater attention.
- Potential for human error contributes its own share to weaken the internal controls.

- Possible collusion between persons operating the internal control and Employees of the client-enterprise or outside parties may render the controls ineffective.
- Sometimes, persons responsible for exercising control may themselves. Circumvent the control procedures
- Change in conditions may tender the control procedures inadequate or altogether superfluous.
- Top management of the client-enterprise may manipulate transactions or estimates and judgments to defeat the objectives of internal control

2.2.4 Study and evaluation of internal control for external audit

If internal control is effective, the auditor may confine his audit procedures only to a representative number of transactions and avoid a detailed verification of every transaction which will be costly both in terms of time and money But before placing reliance on the internal control system, the auditor must properly evaluate the control system and identify its strong and weak points to design his audit procedures accordingly.

Study and evaluation of the existing internal control system should be done As follows:

- **Determination of established control mechanism:** The internal control of any enterprise will have three elements, namely, (a). the overall control environment; i.e. policies and procedures for monitoring business operations; (b) the accounting system-whether manual and/or electronic, and consisting of procedures and document to identify, assemble, classify, analyze, record and report the transactions and maintain accountability; and (c) the control techniques, being used to minimize the risk of error, fraud, and misstatement. The auditor should carefully go through all the available literature concerning the accounting system of, the enterprise, such as organization chart, accounting manual, circulars, job description, accounting records and the forms of registers in which these are kept and the flow charts. These will enable him to understand the authority-responsibility relationships, procedural requirements in the case of different transactions, and the route followed by them. The information so obtained should be supplemented by interrogating the personnel involved with the system to confirm that the system is being actually followed in practice.

Where written instructions or procedures of the enterprise are made a Part of the audit working papers, the auditor must also record his comments as to whether the internal control system as originally installed by the management is being complied fully.

- **Compliance and substantive audit' procedures to test controls.**

The auditor should next identify the control on which he intends to reply and test them to ascertain that they have been properly established and operated as stated, throughout the audit period.

To this end the auditor should apply appropriate compliance procedures. Compliance procedures are tests designed to obtain reasonable assurance that the internal controls on which audit reliance is to be placed, are in effect and have operated effectively throughout the period under audit. They include-(a) tests by. way of inspection of documents supporting transactions to gain evidence that controls have operated properly, and (b) enquiries about the observation of controls which leave no audit trail, for example, to determine who actually performs function rather than whose supposed to perform it Thus, compliance procedures may be applied to test internal control as to (a) authorization, (b) processing of transaction in a particular manner, (c) substantiation of transactions, such as, reconciliation of cash and bank balances; and (d) physical safeguards such as segregation of work between record keepers and stores handlers.

At times, side by side with compliance, procedures, the auditor may also be required to apply substantive procedures. A substantive procedure is meant to detect misstatements in financial statements and includes-(a) analysis of financial information by establishing relationships between financial and non financial, data; and (b) detailed tests of Balances by confirmation, direct observation, vouching, etc.

Combination of compliance and substantive procedures can forcxample is made in testing the bank reconciliation statement; because in this case first the auditor will obtain evidence as to whether the statement is being regularly prepared or riot (compliance procedure) and also evaluate the propriety of reconciling the items stated in the account (substantive procedure).

- **Evaluation**. Having gathered the relevant information to the control system, the auditor can now compile it for his future use Such compilation may be in the form of-(a) a narrative description, (b)a questionnaire with a set of questions to be answered by a "Yes,1t "No" or "Not Applicable" by the audit staff and in same cases by' accounting executives of the enterprise, or (c) a flow chart giving a graphic presentation of each of the company's control systems, the objective in each case being to describe the existing control system. He will also be able to identify the areas and the level of risk of mis-statement there in, based on the evaluation of strong and weak points of the internal control.

In case the internal control. System is found to be strong, only a limited number of audit tests will be necessary to confirm the initial evaluation and then the auditor can safely rely on it for the purpose of expressing his opinion on the authenticity of the financial statements of the enterprise. On the contrary, if the control system is apparently weak, the audit programmed will have to include comprehensive audit tests and procedures, and the auditor will have to carefully assess the effect of such weakness on the authenticity of financial statements

- **Communication of weaknesses in internal Control system.**

The auditor may report to the management as regards the weaknesses noticed by him in the internal control system and. its likely effect on the truth and fairness of representation in the financial statements. The report of weaknesses is also called "letter of weaknesses;" Such a report will serve two purposes. One, it will enlighten the management as to the

weaknesses of the system and Persuade them to carry out necessary reforms therein. Two, the auditor can cite it in own defense against any charge of negligence on his part. Communication of weaknesses of the internal control system to the management will not by itself shield the auditor from liability. But in such a case he will be entitled to state in his report that because of the said weaknesses, he has not been able to place reliance on the internal control system. In the letter of weaknesses, the auditor may also make suggestions as to improvement of the control system.

If a subsequent review of the system shows that his recommendations have not been given effect, he should highlight this fact and continue to do so until the management has implemented them. If necessary, he should also assist the management in giving effect to his recommendations.

2.3 METHODS OF EVALUATION OF INTERNAL CONTROL SYSTEM

The following methods may be used to determine the adequacy of the internal control:

(a) Narrative record,

(b) Questionnaire and

(c) Flow chart.

- **Narrative record:** It contains a complete written description of the internal control 'system of the enterprise as actually found in operation by the auditor The method of keeping a narrative record may be usefully employed in a small business where the internal control system may generally be weak. According to Cashing and Owners; it allows flexibility and can be adapted to any type of enterprise. The type and extent of narrative record will vary according to the requirements and individual judgment of each auditor. For example, if one auditor requires a description of difficult it features of internal control relating to broad functions such as sales, purchases cash payments, etc., and another may show preference for comments only on the discovery of the defects in internal control.

- **Questionnaire.** Internal control questionnaire is an important and effective method for appraising the intern.a1 control system. For this, reason, it is also quite common. The questionnaire contains a set of questions the answers to which provide a valuable insight into the functioning of the' internal control system within the enterprise.

The auditor may prepare a standard questionnaire to use with suitable modifications in the case of all audit engagements, or he may prepare fresh one for each audit engagement. The Institute of Chartered Accountants of India has published an Internal Control Questionnaire for the use of auditors. This can be duly modified to suit individual requirements.

The questions should be so designed that an answer can be provided by a mere ticking of the appropriate word, "yes", "No" or 'Not Applicable," though there is space for comments or explanation in regard each answer. The auditor can himself complete the

questionnaire as he progresses with his observation, testing and evaluation of the internal control. However, in the case of certain questions, answers can only be provided by officials of the enterprise.

Questionnaires are generally favored in the case of audit of large enterprises because they save considerable time for the 3llditor by eliminating the need for preparing a programme for each engagement. Yet another advantage is that since the questionnaire contains questions in regard to all aspects of internal control, there is little chance of any omission of important review procedures.

- **Flow charting:** A flow chart is a graphic presentation of any system. It uses symbols to indicate the relationships between different parts of the system and operations of each part and the system as a whole.

A flow chart for the purpose of study and evaluation of the internal control system helps to depict the flow of. Business transactions of different types, the documents raised in the process and how these are treat. A flow chart is an effective visual medium for proper study and eval'uat1on of the internal control. It. enables the auditor to know ~e strengths and weaknesses of the internal control system and what audit tests and procedures will b~ ,necessary to arrive at an opinion as regards the fairness of the representations made in the financial statements.

Drawing of a new chart

There are many approaches to the drawing of a flow chart, including that which is used by computer programmers. However, since the purpose of a flowchart in the case of an audit examination is to study and evaluate the efficacy of the internal control system, simplified flow chart should be enough.

Accordingly, the internal control system is depicted with the help of symbols, figures and code references with the minimum amount of narrative explanation. There can be many symbols to indicate the flow of transactions but some of them have acquired wide acceptability. The movement of symbolized documents and information can be shown horizontally or vertically. The vertical columns can represent departments, various sections within a department or individual employees. The choice of a department or individual for representation by a vertical column will depend on his importance and criticality to the internal control system.

The following are generally considered adequate to prepare a flowchart:

Directional flow:

This symbol indicates the flow of processing. Generally, it is shown from left to right though in some cases it can also be from top to bottom. In case a document takes two or more paths, the symbol may be suitably varied as follows:

Document or report:

The rectangle shape indicates a document with the name of the document written inside

it. If two or more copies of a document are used for the purpose of control, it is indicated as follows, overlaying each other and bearing the copy number:

Flow chart explained

In the flow chart on the previous page the first point in flow of document is the receipt of orders. Upon receipt of an order, four copies of the Sales Order (SO) are prepared on renumbered forms. The orders received by mail are then filed away in alphabetical order.

The four copies of the S0 are sent to the Packing and Dispatching Section where the quantity to be actually supplied against the S.0 is mentioned on each copy. The first copy of the S.O. is sent from here to the customer and it thus goes out of the system. The second copy is sent to the Invoicing and Account Section. The third copy, in the cue local supply, is handed over to the delivery man who upon Securing the customer Signature. Thereon after delivery of goods returns it to the Packing and Dispatching Section is filed. Date-wise In the case of out-station supplies, the third copy is handed over to the forwarding agent who, after delivering the goods to the carriers, returns it to the Packing and Dispatching Section again to be filed date- wise. The fourth copy is reverted to the order clerk who enters all the particulars, including the date of supply of goods, in the Order Register.

In the invoicing and Accounts Section, the second of the S.D. received from the Packing and Dispatching Section serves as the basis for preparation of the invoice in quadruplicate on pre-numbered forms. Of the four copies of the invoice, the first is sent to the customer, the second to the accounts clerk to make appropriate entries in the customer's account in the ledger and to be filed with him, the third to the Stores Clerk to make entire in the Stores Account and the fourth to the clerk maintaining the Sales Journal for suitable entry and. file.

Compliance procedures explained

- Compliance procedures performed by an auditor have two objectives-(a) that the internal controls intended to be relied won by him have operated generally as identified; and (b) that they functioned effectively during the period of intended reliance, though this does not rule out occasional deviations.
- Deviations from control procedures may be due to change in key personnel, seasonal fluctuations in volume of transactions, and human error. Compliance procedures should appropriately take into account such changes and fluctuations.
- Results of compliance procedures would enable the auditor to evaluate if the
- Internal controls are adequate for his purpose.
- If the auditor concludes that it will not be appropriate to rely on any internal controls to the extent intended, he should see if there are any alternative controls which may be relied upon for the purpose. He may also modify the nature, timing or extent of his substantive procedures.
- Compliance procedures should normally be applied to selected transactions. From the entire period under audit if the transactions of a shorter period only have been tested, the auditor should see what needs to be done to obtain reasonable assurance as regards transactions of the rest of the period.

2.4 INTERNAL CHECK AS A MEANS OF INTERNAL CONTROL

Internal check is a valuable part of internal control. It denotes such an arrangement of duties among the staff that the work performed by one individual is indeperidently checked by another in the routine course, such that errors and fraud are prevented, or discovered without delay. According to Spicer and paler, "internal check is an arrangement of staff duties where by no one person is allowed to carry through and record every aspect of a transaction so that, without collusion between any two or more persons, fraud is prevented and at the same time the possibilities of errors are reduced to a minimum."

Under the system of internal check, care is taken to ensure that no one person alone handles a transaction completely from beginning to end and the work of every person is in the ordinary course checked by another person· in the same or another department An excellent example of internal check is to be seen at the time of cashing of a cheque at any bank. The cheque is produced at the counter where the clerk issues a token and enters the token-number on the back of the cheque and in the token book. The cheque is then passed on to the ledger clerk who verifies the credit balance in the account of the customer and makes the debit entry therein for the amount of the cheque. The cheque is then sent to an officer who compares the signature on the cheque with the specimen signature of the client and passes it for payment. The cheque is then sent to the cashier who makes the payment against the token and records it in his cash register.

2.4.1 Objects of Internal Check

- **Proper division of work**. Division of work based on each individual's ability, training and specialization leads to an overall efficiency and effectiveness. At the same time, the object of proper staff development through appropriate and timely change of work is also accomplished.
- **Fixation of responsibility**. The total work is divided into small units such that it can be precisely defined and responsibility for the same fixed on individual workers. Due to clear determination of responsibility, each member of the staff knows what is expected of him, and also that for any error or fraud originating or. going undetected at his end, he alone· will be held responsible.
- **Minimizations of errors and fraud**. As the work performed by each individual or department is in the ordinary course checked by another individual or department, there is an effective check on the tendency to be careless or dishonest at one's work. As a result, there is considerable reduction in the incidence of errors and fraud.
- **Early detection of errors and fraud.** Because of an independent checking of checking individual's work by another, any error or fraud committed by any employee is likely to be discovered in time by another, such that the resultant loss to the enterprise is minimized

- **Reliability of books of account**. If an enterprise is operating an effective system of internal check, its books of account and other records are, readily relied upon by interested parties. In such a case, even the statutory auditor confines his examination to selective test-checking, thus avoiding the need to undertake a detailed examination of each and every transaction.
- Early preparation of final accounts. Accounting data emanating tinder an effective system of internal check can safely be used to prepare final accounts of the business in time.

2.4.2 Principles of an effective internal check system

- Authority duties and responsibilities of each member of the staff should be clearly defined
- Division of work should be based on the capacity and capability of each individual member.
- There should be no over-lappin5 or duplication of work at any level.
- Division of work should be so designed that no single individual is allowed to perform any work single-handed from beginning to end.
- Routing of the work should be so arranged that the work performed by one individual is automatically, and in the ordinary course, checked by another individual or department
- There should be regular rotation of employees from one work-centre to another to ensure against errors and fraud and to broaden their work experience.
- Employees should be carefully selected, and properly trained for the job· to be done by each of them.
- Employees should be given clear-cut instructions, whether Oral or
- Written, so as to enable them to perform their Work in an orderly and efficient manner. .
- At periodic intervals, employees should be required to go on leave so that any errors or fraud committed by anyone could be detected by his substitute during the farmer’s leave period.
- There should be self-balancing system of accounting providing for control of subsidiary ledgers through an account in the general ledger.
- There should be a system of perpetual inventory control providing for continuous accountability. . .
- Use of mechanical and electronic equipment such as cash registers, book-keeping machines, calculators, cheque signing machines and computers should be encouraged.

- The filing of vouchers should be done systematically, whether number wise or date-wise.
- The incoming mail should be opened by a responsible official who
- should list all the letters, cheques and money orders received, and pass them on to the clerks concerned after securing individual
- acknowledgement
- Cash receipts should be daily deposited in the bank.
- Cash received after banking hours, and cheques, drafts, shares and securities should be under the custody of a responsible official, who should also not be allowed to handle the work for a long duration.
- There should be an effective Control over all purchases, receipts and issue of goods.
- Correspondence with debtors and creditors should be under the charge of a responsible "person.
- Major assignments like verification and valuation of stock. Sales, payment of wages, etc. should be under strict vigilance and control.

2.4.3 Advantages of internal check

- Proper division of work is allocated among the members of staff keeping in view their qualifications and experience.
- **Efficiency and economy.** Division of work based on expertise promotes efficiency of the staff and leads to overall economy in operations.
- **Early detection of errors and fraud.** As the work of each worker is in the ordinary course checked by another errors and fraud are detected early.
- **Prevention of errors and fraud due to moral check**. Assurance as to subsequent checking of each employee's work by other acts as an effective impediment to commission of errors and fraud.
- Early preparation of final accounts. It is easy to place reliance on the books and accounts of an enterprise with a strict system of internal heck consequently. It can prepare its final accounts without going into the veracity of the data allover again.
- **Increased profitability for owners.** Overall efficiency and economy of operations leads to' increased earnings for the owners of the enterprise.
- **Convenience to auditor.** Where an enterprise operates an effective system of internal check. die external auditor can safely undertake test checking of a select number of representative transactions and documents to determine the type and extent of audit tests and procedures to be applied on the basis of his findings.

Disadvantages of internal check

- **Complacency among high officials.** Persons in charge of the control function are inclined to be less serious because of their belief that under an effective system of internal check. The possibility of an error or fraud is quite remote and that under a sound system of internal check nothing can go wrong.
- **Costly for small businesses.** Establishment an internal check system involves additional costs which a small business may not be able to afford.
- **Risky for the auditor:** An auditor is inclined to skip. Detailed checking of books and accounts in 'the case of an enterprise operating an effective internal check system. However he cannot escape liability for negligence if he fails to apply proper compliance and substantive procedures to test the efficacy of internal check.

2.4.4 Internal check as regards cash receipts

Checking of all cash transactions' should be given utmost importance because it is here that employees may be tempted to commit fraud. For example, (a) receipts may not be entered in the cash book; (b) record of cash received may be understated by preparing duplicate receipts for amounts less than what is actually received; (c) part of the money received may be held back lapping it with subsequent receipts; (d) amount of a cheque may be increased after it has been signed; (e) a cheque may be made payable to wrong payee; if) cash sales may be treated as credit sales charging the amount to fictitious debtors and so on.

While evaluating the system of internal check· as regards cash the auditor should pay particular attention to the following:

- All incoming mail should be opened under the supervision of a responsible person who has nothing to do with accounting and administration of cash transactions.
- Immediately upon receipt of cash or cheques, a rough record of the amount should be made and the· documents accompanying cash or cheques should indelibly marked with the amount of the receipt.
- All incoming cheques and postal orders should be cancelled by means of a stamp with a crossing of "Not Negotiable-Account Payee Only."
- There must be specific instructions as regards receipt of cash by the cashier, traveling salesmen and others and the manner of its record. In any case no one should be allowed to accept cash without issuing a proper receipt on pre-numbered forms.
- All cash and cheques must be banked immediately after receipt. Where this is not possible for some reason, the limitation as to the un banked amount and the maximum period for which it may be so retained, must be clearly specified.

- Bank paying-in slips should not be prepared by the same person who is in charge of making actual deposits in the bank. Preferably, the counterfoils of the bank paying-in slips should be written by the person who prepares the receipts to be issued to the payers. The other part of1he paying-in-slip which is retained by the bank should be prepared by the cashier.
- Counterfoils of the paying-in slips should be regularly checked with the. Document recording· the receipt of cash and cheques.
- Receipts to be issued against cash and cheques should be printed and serially numbered, and each number should be duly accounted for.
- There should be an independent daily control of 'Cash receipts, such· as checking of the first list of cash receipts (prepared by the person in charge of opening incoming mail) with the summary of receipts issued or posted to the· payers and entries in the respective ledger accounts.
- Cash for disbursement purposes should not be withdrawn from cash receipts.

Cash sales

- Cash sales may take the form of sales at the counter, sales by traveling salesmen and postal sales.
- **Sales at the counter:** The salesmen authorized to sell goods at the counter should be specifically named.
- Cash sales invoices or cash memos should be pre-numbered and be of different colors for salesmen at different counters.
- The salesman at each counter should make four copies of the cash memo, three of them to be handed over to the customer and the fourth to be retained by him.
- The customer should be required to carryall the three copies to the cashier who after collecting the amount and recording it in his cash register, should return two copies to the customer duly stamp-marked "Cash paid".
- The customer should be required to hand over one copy of the cash memo at the counter where the goods purchased by him arc to be delivered to him. In bigger establishments a copy of the cash memo may also have to be handed over to the gate-keeper before the customer is allowed to check out of the place .
- At the end of the day, duplicates of the pre-numbered cash memos should be checked with the summaries of cash sales prepared by the counter-salesmen, cashier, and delivery counter-clerk (in some cases, also the gate-keeper).
- Daily cash receipts should be deposited in a bank on the same day.
- Where cash recording machines are used, the total of cash received as shown by the machine, should be checked with the amount actually banked.

- **Sales by traveling salesmen.** Ordinarily, credit customers should send the remittances by post and not hand over cash to any representative of the enterprise. However, traveling salesmen may be permitted to collect cash from debtors as, for example, where it is necessary for enforcement of credit terms. If traveling salesmen are allowed to collect cash from debtors, the following precautions must be observed:
- Traveling salesmen should be issued with pre-numbered rough receipt books.
- Final receipts against receipt of cash by a traveling salesman should be issued from the head/branch office to which the salesman is attached.
- Customers should be asked to contact the head/branch office if a final receipt is not mailed to them within a stipulated period.
- Traveling salesmen should be instructed to remit the entire cash collection to the head/branch office to which they are attached, without making any deduction for salary or' commission payable to them.
- Head/branch office should regularly send statements of account to individual customers to keep them informed of the latest position as to their liability.
- Special attention should be paid to customers' accounts which have become overdue.
- There should be surprise transfer of traveling Salesmen from one area to another.
- **Postal sales.** There should be a separate register to record sales by post or V.P .P. As soon as cash is received against a V.P.P. sale, it should be entered in this register and from. There it should be posted to the Cash' Book. Separate bank pay-in-slip should be prepared to deposit cash received against postal sales. At frequent intervals, a responsible officer should check the V.P.P. Register for goods which have been returned, as also those against which payment has not been received.

2.4.5 Internal check as regards cash payments

There should be an effective system of internal check with regard to all payments, e.g., payment in cash, by cheque and bank transfers. The following points should be carefully noted in this regard:

- Ordinarily, the person in charge of making payments should have nothing to do with the receipt of cash
- All payments should, as far as possible, be by cheques excluding, of course, petty cash payments which should be in charge of a separate person.
- Unused cheque books should be under the custody of a responsible person
- Persons responsible for preparing cheques should be clearly specified; Before passing a bill to an invoice for payment, it should be ensured that the enterprise has in fact secured the goods or services as stated therein.
- As soon as a cheque has been prepared, the relevant bill or invoice should be stamped "Paid" so that it is not, by mistake or otherwise, gain passed for payment.

- Only persons duly authorized in this behalf should sign cheques.
- Limitations as to the amount up to which cheques could be prepared and signed in the ordinary course, should be clearly specified.
- In case any payment is of a special nature, or involves a big sum, there should be proper authorization for it from a high official and the cheque should preferably be signed by more than one official.
- There should be specific instructions not to sign cheques in advance or in favor of the persons signing them.
- Each cheque should be accounted for, and the cancelled cheques should be carefully preserved.
- Bank reconciliation statements' should be prepared at regular intervals, preferably by an independent person.

Petty cash payments

- Petty cash payments should be under the charge of a person other than the one looking after payments by cheques.
- Petty Cash Book, detailing payments of a petty nature, should .be maintained as per the imp rest system and the amount of the imp rest should not be increased without proper authorization.
- The Petty Cash Book should be written up daily and the balance should be agreed with the cash in hand at the close of each day.
- Payments should be made only on the authority of properly approved. Vouchers which should be marked "Paid" after every payment.
- The work of employees who arc connected with the payment of cash should, as far as possible, be kept separate from one another.
- All "paid" vouchers should be properly filed and kept under the custody of the petty cashier.
- At regular intervals, the cashier or any other responsible official should check the Petty Cash Register with the vouchers.
- The petty cashier should be instructed no. to lend money to anyone, Or to spend it for purpose other than those specified.

Bank transfers

Bank transfers should be made only under written authority from a senior official. Multiplicity of authority in this respect should as far as possible be avoided.

Internal Check as regards wages

The system of internal check as regards payment of wages needs to be carefully studied. This is because, particularly in a large establishment employing a number of workers, there is possibility of errors or fraud in the preparation of lime and piece wage records or wage sheets:

The following points in regard to internal check as regards wages deserve to be noted:

- All appointments, removal, and fixation or alteration of wage rates should be in writing, and authorized by a competent official.
- The work relating to preparation of wage sheet should be sub-divided among different employees; the work performed by who should not only be checked by one another, but also is complementary to each other.
- Records as to time and piece wages of permanent and casual workers should be properly checked.
- The method by which, deductions are to be made from workers' remunerations should be clearly notified.
- The foreman should countersign records as to time and piece wage amount, number of hours worked, number of pieces manufactured, overtime etc.
- The number of workers shown in the wage sheet should be checked with the official list of workers with the personnel department, and so also the rates of wages. Checking of these, together with the, time and piece wage records countersigned by the foreman or supervisor, will prevent insertion bf dummies or ghost workers in the wage sheets.
- Close attention should be given to overtime payments which, in any case should be made only on written authority from the head of the department concerned.
- Incentive bonus payments for extra output to selected workers should be checked a number of times during the year, to ensure that (a) the output per worker has been recorded correctly; (b) the rates are correct and properly authorized; and (c) the period of absence has been duly excluded.
- The accounts -department, to which the wage sheets are sent must carefully check, the totals, both gross and net, of wages payable to individual workers and also ensure that deductions on account of provident fund, annuity and pension funds, insurance, income tax etc., arc properly made. .
- Proper arrangements should be made for the drawing and encashment of the wages cheque, and the amount of this cheque should be equal to the net total in the wages sheet.
- Wage-packets should be made up by persons who have nothing to do with those preparing the wage sheets.
- While drawing money from the 'bank, CID-0 should be taken to see that right amount of notes and coins arc available for payment to individual workers.
- Payment of wages should be under the supervision of a responsible official' and it should be done by a person who is not connected with preparation, of wage sheets or wage packets.
- There should be specific' instructions as regards the procedure to be followed for dealing with unclaimed wages. These should include preparation of a list of unclaimed amounts and immediate deposit of the sum in the bank in a separate account.

- Subsequent payment of unclaimed wages should be on production of individual time or piece wage records and through the petty cashbook, upon authorization of a person other than the cashier.
- Payment of wages in advance should be properly controlled.
- Senior officials should do, surprise, checking, of wage, sheets and wage. payment to ensure that (a) fake names are not shown in wage sheets; (b) wage rates are not overstated or deductions are not understated; (c) false overtime payments are not recorded; (d) wages are paid to the persons consumed and no one is allowed to substitute himself for workers who are not present:

2.4.6 Internal check as regards sales

- Persons authorized to accept orders and to pass these on for necessary production or supply should be clearly specified.
- Only a senior official should have authority to grant credit facility.
- All incoming orders should be serially numbered and recorded in the Orders Received Book. As far as possible, only a duplicate copy of any order should be passed on for production or supply.
- The person having authority to examine and record the dispatch of goods should not be .from among those who are in charge of stock maintenance of invoicing duties.
- There should be a well-established procedure for regular comparison of record of goods dispatched with original orders, dispatch memos and invoices.
- Invoices should be prepared in triplicate. Billing should be done correctly and under agreed terms of discount or otherwise. Each invoice should be prepared on the basis of the dispatch memo or challan sent in by the Dispatch Section, and there should be an invoice for every dispatch memo or challan, and every item of goods should be properly billed.
- Duties as regards checking of quantities, prices, discounts and totals in the invoices should be dearly earmarked.
- Two copies of the invoice should be sent to the customer concerned who should be asked to return a copy thereof with his' signatures as a proof of the receipt of goods mentioned therein.
- From the third copy of the invoice, particulars of the sales should be recorded in the Goods Outward Book (to be checked at regular intervals with the Orders Received Book), Sales Ledger and stock records.
- There should be a proper procedure to follow the goods sent on approval, sale or return, free of charge, etc.
- Goods returned by customers should be entered in a separate register, e.g., Goods Inward Book, and the reasons for the return should be recorded therein.

- Issue of credit notes for goods returned by customers should be as per an established procedure and authorized by a senior official.
- Issue of credit notes for price adjustments, errors in invoices, or special allowances should be authorized by a senior official. Credit notes should be renumbered and unused forms should be in proper custody.
- Where goods are dispatched in one accounting period but invoiced in the subsequent one, Care should be taken to ensure that they are properly invoiced later and the goods already dispatched do not form part of the inventory records of the preceding accounting period.
- Authority to deal with customers' enquiries, overdue accounts, and· writing off of bad debts, should rest with a senior person.
- There should be control accounts as regards debtor's ledger.

2.4.7 Internal Check As Regards Purchases

- Purchases should be supervised and controlled by a separate department to be called Buying or Purchase Department. The Department should be headed by a responsible official.
- The department must maintain a list of approved firms with whom. orders for making purchase are regularly placed.
- The purchase cycle should begin with the placing or a requisition by a responsible person with the Purchase Department.
- Each section or department of the enterprise should be given separate requisition forms bearing serial numbers. The Purchase Department should keep a separate record of requisition forms received from different departments.
- Upon receipt of a requisition the Purchase Department should send letter of inquiry to the listed suppliers for quotation of the price, freight, and delivery terms.
- After examination of the terms quoted by suppliers, the Purchase Department should place an order with the supplier selected by it. It should also send copies of the order to the Accounts Department, Stores Department and the department which has made the requisition. In case an order has been placed with a supplier other than the one who had quoted the lowest price, the reason for the S&'11e should be recorded.
- The procedure relating to receipt, inspection, acceptance and transfer of the goods to concerned departments, should be clearly laid down.
- Receipt of goods should be recorded in the Goods Received (or Inward) Register. The person in charge of receiving the goods should prepare a Goods Received Note (or Materials Received Report) and send a copy thereof to the Accounts Department and to the department upon whose requisition the goods have been ordered..·

- Goods received should be inspected to see that they are exactly as ordered. This should be done with the assistance of the department which has requisitioned the goods. The inspection culminates in the preparation of Goods Inspection Note a copy of which should be sent to the Accounts Department and the department making the requisition. Where possible, Goods Received Note and Goods Inspection Note may be combined.
- Upon receipt of the supplier's invoice, the Purchase (or the Accounts) Department should check it with the order and the Goods Received/Inspection Note to ensure that the rate, discount, quality and quantity of the goods are exactly as earlier agreed.
- After due checking, necessary particulars of the purchase should be recorded in the Purchase Register and the number of the purchase order should be marked on the invoice.
- The Accounts Department should not make any payment to the supplier unless the invoice has been passed for payment by an authorised person after due verification.
- In case any advance sum has been paid to a supplier against the order, it should be deducted from the total amount of the bill and only the net amount' should be paid to him.
- Goods received should also be entered in respective stores ledgers. From there, the relevant entries· should be passed in the stock (bin) cards.
- In case any goods are rejected on account of being defective or for any other reason, they should be returned to the supplier and not entered either in the stores ledger the bin cards.
- For the goods returned to the supplier, credit note should be obtained from him (against a debit note prepared in his name)' failing which a debit entry should be passed in his individual account.
- Where only a part of the goods are returned to the supplier as being defective, the items to be entered on the bin cards (or Stores Ledger) should be those actually accepted, and the Goods Received Note should be prepared accordingly. In such a case, either the bill is passed only for the value of goods actually accepted, or a fresh bill is demanded from the suppliers. In such a case as also where the supplier has overcharged in respect of any of the items, a credit note may also be obtained from him.
- All incoming credit notes should be numbered and stamped the same way as invoices. These should also be checked with the advice note covering the return of rejected goods to the supplier.

2.4.8 Internal Check As Regards Stores (inventory)

Stores are particularly vulnerable to misappropriation. These may also at times be used to cover payments other than those relating to the purchase of stores. Therefore, the internal check system in relation to stores must be given careful attention. The following points 'deserve to be noted in this respect.'

- Responsibility as to safeguarding and maintenance of stores should be clearly determined.
- Persons engaged in maintenance of inventory records should have nothing to do with stores.
- There should be a separate place for each category of stores.
- For proper stores control, a system of code number, should be established

  For each item and the place where it is kept, the use of code numbers will prevent unauthorized purchases and purchases by unauthorized persons.
- Bin cards should be used for maintenance of stores. These should Contain particulars to receipt, issue and balance of stores.
- There should be an independent checking of stores by a responsible person who is not involved in any way with purchase, issue or maintenance of stores.
- Procedures with regard to stores held outside the business, or goods held on behalf of others, should be clearly specified. Goods kept· at outside warehouses should be properly controlled, and inspected.
- Stock taking should be done at regular,' even at times irregular, intervals.
- Stores records should also be compared with those of corresponding periods of the previous year so as to discover possibilities of material omissions and/or inclusions.
- Responsibility for the issue of stores should be fixed on an individual/department the stores should be issued only on the authority of a requisition or demand note duly sanctioned by a responsible person.
- The system of requisitioning stores should be carefully gone into to ensure against wastage or losses.
- Each requisition should contain the name or code number of the department and description of the stores required, and these should be checked with the list of stores commonly used by the department concerned.
- At times stores issued Lo one department may have to be transferred to another. This should be done either by returning the goods to the stores and re-issuing them, or by a, direct transfer and in case of either or both, suitable adjustments should be made)n the Stores Issue Register.

- Entry into stores should be regulated by permits so as to ensure that persons going outside do not remove any goods without proper authority
- For every issue of stores, there must be an entry in the relevant bin cards which should be duly balanced.
- Wherever fresh supplies are received or stores are returned by some department, appropriate entries should be made in the bin cards.
- Stores ledger should be maintained by a person who is not concerned with receipt or issue of stores.
- There should be a separate. Card for each item of the stores, and description and code number of each item should be clearly entered on it.
- Stores cards of different colors or sizes should be used for easy identification
- There should be a regular checking of stores ledger with the bin cards. Goods Received Notes, Goods Returned Note and requisition slips.

2.5 INTERNAL AUDIT

Internal audit may be defined as "the continuous and systematic process of. Examining and reporting on the administrative systems and accounting methods of a company or group of companies. It is generally carried out by employees of the company with a view-(a) to confirming that the policies of management are being properly executed and drawing attention to those areas where policies appear to be inadequate; and (b) to verifying that the information used by management to control the undertaking is both adequate and accurate."

Internal audit is performed by employees of the enterprise especially appointed for this purpose, though sometimes outsiders may also be hired for the purpose. In either case an internal auditor is not independent of the owner/management which has appointed him.

According to the Manufacturing and Other Companies (Auditor's Report) MAOCARO, 1988, in the case of a specified company, the statutory auditor is required to report if the internal audit system of the company is commensurate with the size and nature of .the business of the company. A specified company is one whose paid tip capital exceeds Rs. 25 lakhs or whose average annual·· turnover in the three years immediately preceding the financial year, exceeds Rs. 2 crores.

Objects

Briefly, the objects of internal audit may be stated as follows:

- Evaluation of accounting and administrative systems and controls. Internal audit is concerned with ensuring effective and efficient system of accounting control, standard cost control, budgetary control and other administrative controls.

- Compliance with established policies and procedures. It is concerned with reporting to the management it as to the compliance with pre- determined policies, procedures and standards of performance.
- Safeguarding of business assets. It ensures proper accounting and custody of business assets. It reports to the management about utilisation of existing assets and adequacy of return from investment.
- Reliability of management data. It ascertains the reliability of financial and operating reports prepared throughout the enterprise. The management relies on the reports of internal auditors as they provide a continuous assurance as to validity of records and transactions of the enterprise.
- Suggesting improvements. If the internal auditor discovers any inadequacy in the working of the internal control system in any operational area, he makes appropriate recommendations to the management for improvement of the system.

2.6 EXTERNAL AND INTERNAL AUDIT

Points of similarity

External and internal audits are closely similar as regards-(a) internal Control system; (b) ascertainment of adequacy and effectiveness of the accounting system so that its output is reliable; (c) verification of assets and liabilities; and (d) mean 0f examination, e.g., observation, inquiry, statistical comparison, testing, etc,

External and internal audits differ in the following respects:

- **Need.** In the case of an enterprise which is under a legal obligation' to have its accounts audited, appointment of an external- auditor is compulsory. However internal audit is not .compulsory except in the case of a company as specified in the Manufacturing and Other Companies (Auditor's Report) Order (MAOCARO) 1988. An enterprise- will provide for it only if it finds it useful.
- **Status of auditor**. The external auditor is independent of the enterprise which engages him. The internal auditor is, on the other hand, often an employee of the enterprise.
- **Scope.** The scope of a statutory external audit is determined by the law applicable to the enterpriset.U1der audit. It cannot be curtailed in any manner. In case of non-statutory external audit, the scope is determined by the agreement between the client and the auditor. However, the scope of internal audit is determined by the management and may be enlarged or curtailed at will

- **Approach.** The external auditor's approach is determined by the duties and liabilities cast on him - in the case of statutory audit by the relevant law, and in the case of non-statutory audit, by the agreement under which he has been engaged. In either case, his duty is to render an opinion on the truth and fairness of the assertions under his review. However, an internal auditor's approach is governed by ·his duty to ensure that the accounting system is adequate and effective such that the information presented to' the management from time to time is true and discloses all material facts.

- **Responsibility**. The external auditor's responsibility is primarily to the owners who have appointed him; though in certain cases it may also extend to interested third parties who have acted on the faith of his opinion as regards the financial statements examined by him. However, the internal auditor, who is an employee of the management, is only responsible to the management.

Coordination

However, despite the divergence in scope, approach and responsibility of the internal and external auditors, the work of both can be coordinated in .many respects such as determination of the adequacy of the established internal control, verification of the assets and liabilities, and detection of fraud and errors. Besides avoiding audit duplication, such coordination will also enable the external auditor to save considerable time and effort in his own audit examination.

2.7 INTERNAL CHECK AND INTERNAL AUDIT

The main points of distinction between internal check and internal audit are as follows:

Internal check	Internal audit
• It is'an integral part of the current routine operations and helps in providing an automatic proof of clerical accuracy. It is an in-built part of the accounting system under which the work of each employee is checked by another and no employee is in charge of .	It is an independent appraisal activity with in the organization for a review of accounting, financial and other operations as a basis for service to the management.
• The work is continuously checked in the very process of its being performed	It is a post mortem on work already done and requiring an appraisal as to whether the particular procedure of performing the work is operating properly.

• Separate staff is not necessary. Only duties. Of the existing staff are so arranged that work of on employee is independently checked by another in the ordinary course.	Separate staff is necessary.
• It aims at minimizing errors. and fraud.	It aims at discovering errors and fraud.
• It is a line function.	It is a staff function.

2.8 POSITION OF EXTERNAL AUDITOR AS REGARDS INTERNAL AUDIT

There is to be a proper study and evaluation of the existing .internal control. as a basis for reliance thereon and on determination of extent of the tests to which auditing procedures are to be restricted. Accordingly, it is the primary responsibility of an auditor to appraise and evaluate the internal audit system so as to determine as to what extent it can be relied upon. For, if material errors and fraud remain undetected in the system, they are bound to affect his opinion as regards the truth and fairness of representations made in the financial statements.

According to SAP-7, "Relying upon the Work of an Internal Auditor" issued by the Institute of Chartered Accountants of India, the external auditor should, as part of his audit, evaluate the internal audit function to the extent he considers that it will be relevant in determining the nature, timing and extent of his compliance, and substantive procedures. Depending upon such evaluation, the external auditor may be able to adopt less extensive procedures than would other wise be required.

With the introduction of the Manufacturing and Other Companies (Auditor's Report) Order (MAOCARO), 1988, internal audit function has acquired special significance as the statutory auditor is required to state, in relation to a company having a paid-up capital of more than Rs. 25 lakhs or having an average annual turnover of more thai1 RS.2 crore (or a period of three Consecutive financial years immediately preceding the financial year concerned, and to which the Order applies, whether the internal audit system is commensurate with the size and nature of its business.

If as a result of such evaluation and appropriate interaction with the internal auditor, the external auditor intends to rely upon specific internal audit work as a basis for modifying the nature, timing and extent of his procedures, he should review the internal auditor's work, taking into account the following factors:

- The scope of· work and related audit programmers are adequate for' the external auditor’s purpose.
- The work was properly planned and the work of assistants was properly supervised, reviewed and documented.

- Sufficient appropriate evidence was obtained afford a reasonable basis for the conclusions reached.
- Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.
- Any exception or unusual matters disclosed by the internal auditor's procedures have been properly resolved.

The nature, timing and extent of the external· auditor stets and procedures will depend upon materiality of the area concerned to the .financial statements taken as a whole, and results of his own evaluation of the internal audit function and of the specific internal audit work. His tests may include examination of items already examined by the internal auditor, examination of other similar items, and observation of the internal auditor's procedures.

But the extent to which an external auditor chooses to rely on internal audit will be a matter of his individual judgment and responsibility. This is because is duty bound to exercise due profession care' in the performance of his examination and in. the preparation of his report. Before placing reliance on an internal audit system, the auditor must carefully evaluate it to determine how far it can be' relied upon for the purpose of his examination. He should equally carefully apply proper compliance and substantive procedures based on such evaluation to form his opinion as to the truth and fairness of the representation in the financial statements. He may be held liable if it is subsequently found that he was less than duly careful and diligent in either.

2.9 VOUCHING-AUDIT OF CASH TRANSACTIONS

The main objects of vouching may be stated as follows:

- All transactions connected with the business have been properly recorded in the books of account.
- The entries in the books of account pertain to transactions which are genuinely connected with the business.
- The vouchers in support of the entries are legally valid. in the sense that they are authentic, properly dated, addressed to the business of the client, and are not fraudulent in any respect.
- The vouchers have been carefully processed through each stage of an effective system of internal check.
- The vouchers have been properly authorized.

According to SAP-5, "Audit Evidence" issued by the Institute of Chartered Accountants of India, the auditor should obtain sufficient appropriate evidentiary matter to afford a reasonable basis for an opinion regarding financial statements examined by him. In fact,

auditing as a whole consists of mainly two functions both of which are closely connected with evidence. The first is evidence gathering through inspection, observation, inquiries, confirmation, etc. The second is evaluation of the evidence so gathered from the prompt of View of its validity, adequacy and relevance.

2.9.1 Meaning of Vouching .

Vouching may be defined as "such an examination of the ledger entries as will satisfy an auditor not only that the entry is supported by documentary evidence but that it has been properly made upon the books of account." Vouching "does not mean merely the inspection of receipts with the cashbook, but includes the examination of receipts with the transactions of a business; together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorised, and are correctly recorded in the books of account"

Thus the emphasis in vouching is on ascertaining -

(a) That every entry in the books of account is supported by a voucher and that no voucher has gone unrecorded in the books of account;

(b) That the transaction is genuinely concerned with the business;

(c) That the amount involved in the transaction has been accurately recorded; and

(c) That the entry has been correctly made in the appropriate account. . Vouching is not merely a mechanical process involving the examination of vouchers or documentary evidence with the entries in the books of account. It also includes an inquiry into the genuineness of the transaction, accuracy of the -amount involved therein, and proper posting in the relevant accounts.

2.9.2 Objects of Vouching

Vouching is to be distinguished from routine checking which is concerned with checking the arithmetical accuracy of the books of original' entry and ledgers in respect of castings, carry-forwards, totals and balances. No doubt, vouching includes routine checking but it: goes beyond it and includes an examination of the documentary evidence's, genuineness of the business transaction, propriety of authorisation of each transaction, and its correct posting in the relevant account.

2.10 VOUCHERS

A voucher may be defined as any document which evidences a transaction or an entry in a book of account. It may be in the form of a money receipt, invoice, cash memo bank paying-in-slip, agreement or contract a resolution passed at a meeting of the Board of directors or shareholders the minutes of a meeting, correspondence with parties, and so on.

2.10.1 Kinds of' Vouchers

A voucher may be primary or collateral. A primary voucher is an original evidence of a transaction or entry. Thus written responses to confirmation requests as to debtors or creditors' accounts, purchase invoices or each memos for goods purchase or statements prepared by the bank, are examples of primary vouchers. Collateral vouchers may be in the form of copies of sales invoices, receipts issued to debtors or resolutions passed at the meetings of the Board or shareholders.

2.10.2 Requisites or a voucher

Whether voucher is primary or collateral, it must constitute an adequate, reliable and competent proof in support of the transaction or entry in a book of account to which it relates. "Adequacy" is not to be confides with the number of' vouchers which the auditor is able to collect in support of a transaction or an entry. The important thing is the relevance and authenticity of a voucher.

"Reliability" of a voucher is to be determine4 with reference to the mariner of preparation and maintenance of the vouchers; e.g., whether the voucher is addressed to the firm at its normal business address, and whether it is properly dated, authorized and flied. "Competency" of a voucher will largely depend on the place of its origin. Vouchers originating outside, such as written confirmations obtained from debtors or creditors, may be safely treated as competent evidence. But vouchers originating outside but held by the client, e.g., purchase invoices or bank-statements, cannot be so treated because these can be easily forged or altered. Vouchers process through an effective internal control system can also be relied upon. For example if time wage, cards are prepared as per notification of the personnel department, the time of daily arrival and departure of each worker is recorded by a machine under the Supervision of a gate-keeper, and there is a regular floor-checking by the supervisor, the time wage cards may be safely relied upon.

2.10.3 Examination of vouchers

Vouchers constitute a valuable link between business transactions and their, entries in the books of account. Hence, each voucher should be examined with great care and caution and while doing so the following points must be given particular attention.

- Each voucher should be consecutively numbered and carefully preserved.
- The filing of vouchers should be in the same order in which the relevant entries appear in the books of account.
- It should be addressed to the client - organization at its normal business address. This is necessary so as to accept it as a prima facie evidence of the corresponding transaction being related to the business. In case a voucher has been addressed in the personal name of a director, partner, manager, etc., the original invoice, goods received note, and stock register should be carefully examined to ascertain whether the goods·· purchased are meant for the business, or for the individual to whom the voucher is addressed. If the latter, then relevant records should be examined to see that the individual concerned has been debited with the amount of the voucher and the same has been realised from him.

- It should be properly dated and correspond to the date of the transaction to which it relates and the period under audit. ... .
- It should be authorised by an official properly empowered in this behalf..
- The amount shown in the. Voucher should be correctly· calculated and totaled. Special attention should be given to checking of the amount. shown in figures only, as it is liable to be easily altered. Where the amount is shown both in figures and words, any difference between the two should be properly investigated. .
- If the amount of a voucher exceeds RS.20, it should be properly stamped.
- A voucher should, on the face of it, appear to be genuine and complete as regards all legal and procedural formalities For example, if it has originated outside, it must bear the name of the issuing organisation, whether in print or robber-stamped, and should be signed.
- As a voucher is examined, it should be cancelled with a special rubber stamp and the entry· which it supports should be marked with a· special tick This will prevent the same voucher being produced in support of another entry. But stamping of a voucher should not be confused with its being certified as correct it only means that the auditor has inspected it.
- In case any explanation or. clarification is desired with respect to any voucher, the same should be noted in the Audit Note Book. .
- Each entry should be carefully checked and a clear distinction made· between capital and revenue items of receipt and expenditure, lest any wrong posting should affect the Profit and Loss Account and the Balance Sheet.
- Suitable adjustment entries should be made in case a voucher relates to prepayment of expenses or accrual· of income. Separate schedules should be prepared for these, as also for directors' fees, exceptional and nonrecurring transactions, as these would be useful at subsequent stages of audit
- A pre-receipted invoice should not be accepted as a voucher as this is likely to give rise to double payment, first against credit purchase and' then again against a cash purchase.
- Vouchers by way of resolutions and minutes should be examined with reference to their validity in the light of scope and limitations set out in the Memorandum and Articles of Association, Partnership Deed, etc.
- Duplicates of vouchers, shown as missing from the records, should not be accepted as a matter of routine. Reasons and explanation for the loss of vouchers should be sought from the client in writing and, where possible, the auditor should make an independent investigation, including correspondence with the parties from whom the missing vouchers had originated. In any case, if the auditor is not satisfied with the explanation for any missing voucher, he should state the same in his report.

- There may be certain payments such as wages' or petty expenses for which vouchers are not available. These should be checked with the Wage Register, Petty Cash Book, etc.
- Over-writing or erosion on a voucher should not be accepted. Alteration of any kind should be supported by signature of the maker, with attestation by a responsible official.
- The auditor and his staff should not be afraid to express their ignorance as to the nature arid import of a transaction, or the method of its record.

2.11 CUT-OFF TESTS OR ARRANGEMENT

Audit review is limited to the records of business transactions of a specific period. But accounting is a continuous process as business transactions continue without interruption, round the year. As a result, there is likely to be a mix-up of recording of certain' transactions particularly those which are undertaken on the eve of the year-end; such that transactions belonging to the year under audit may be recorded in the subsequent period and vice-versa.

Errors of this nature may be, unintentional. But there may also be intentional manipulation with a view to "window dressing" the financial condition of the business by improving the working capital ratio, inflating sales, understating purchases, and so on.

The auditor must provide ·an effective check against such practice by establishing timely cut-off points. A cut-off point indicates the precise point at which the year under review bas ended. To this end, he should ask the departments concerned to furnish him with the serial number of the documents {invoices, Goods Received Notes) which constitute the cut-off points as to the creditors, and goods received and sold.

Having determined the point at which all transactions for the year under review have ceased, the auditor should examine all receipts and payments of cash, and Sale and purchase 'invoices for a few days previous to the end of the period under review, and for some period of time subsequent the end of that period, to ascertain – (a) which invoices and transactions entered prior to the end of the accounting year belong to the subsequent year; and (b) which invoices and transactions entered subsequent to the end of the accounting year do actually belong to the accounting year under audit.

According to the "Statement on Auditing Practices" issued by the Institute of Chartered Accountants of India, the auditor should carefully examine the procedures employed to ensure separation of transactions as at the end of one year from those at the commencement of the next year. He should satisfy himself by examination and test-check that these procedures adequately ensure.

- Goods purchased for which property has passed to the client have in fact been included in· the inventories and that the liability has been provided for.
- Goods purchased and provided for have been included in the inventories.
- Goods sold have been excluded from the inventories and credit has been taken for the sales.

2.12 IMPORTANCE OF VOUCHING

Vouching is the essence of auditing. It constitutes the foundation upon which· the super-structure of auditing is erected. The success of an audit engagement largely depends on the care and attention with which vouching is accomplished. Because, while comparison of entries with the relevant vouchers can be done in a mechanical manner, ascertaining the genuineness validity and proper recording of each transaction will require the auditor to look beyond and behind what is immediately visible to him. This will help in discovering all possible errors and fraud, howsoever cleverly committed.

Vouching is often regarded as synonymous with a mete companion of the documentary evidence concerning each transaction with the entries in the original books of account. However, the truth is that it is a searching inquiry into the genuineness, validity and accurate recording of the transaction-whether the transaction did really take place as stated, whether it is wholly and exclusively related to the business, whether it was properly authorized by a competent official, arid whether its effect has been fully and accurately recorded in the books in accordance with the legal requirements and generally accepted principles of accountancy.

However, while vouching constitutes an important part of audit-work" it is not necessary for the auditor in all cases to vouch each, and every transaction In large enterprises with a sound system of internal control, the auditor should apply suitable compliance test procedures, i.e., concentrate his audit tests on a scientifically selected number of transactions, and if vouching of these transactions on a depth-test basis reveals a broad compliance with the system of internal control, he may safely formulate his opinion about the validity of remaining transactions.

However, in the following cases, vouching of a selected number of transactions may not be appropriate:

(a) if the enterprise under audit has a poor system of internal control

(b) if in a small enterprise the internal control system in areas such as division of duties is not complete;

(c) if the enterprise under audit is of a specialized nature, where the number· of transactions, though limited in number, are of specialized type in the case of which application of sampling techniques would be inappropriate, e.g., major capital expenditure, purchase of investments, rents and dividend received, etc.

In fact, whether a business large or small and: whether its internal check system is strong or weak, there is no escape for the auditor so far as his duty q~ reasonable care in respect of

vouching is concerned. If he goes about vouching in a haphazard and reckless manner, he may be held guilty of negligence. In Arbitrage v. Brewer and Knott (77 Act. L.R. 28), the auditors were charged. with being careless in vouching so that fraud committed by the client's clerk went undetected In the Court's opinion, the auditors did not exercise even a moderate amount of inquiry and care and their excuse that "this or that was a small matter" was untenable and the client was therefore entitled to claim damages.

2.13 VOCHING OF CASH TRANSACTIONS

Before the auditor gins to vouch cash transactions he must examine the system of internal control with regard cash receipts and payments. As observed by De Paula, "there are two main objects of a system of cash control. The first is to ensure that all receipts of the business from all sources are accounted for; and therefore, every precaution should be taken by means of internal check to make it as difficult as possible for the receipts to be misappropriated. The second is *to* ensure that every payment has been properly authorized and is a *bonafide* business expense that the action is properly recorded in the books account and that the payee has actually received the amount.'

Internal check as regards cash transactions

An efficient system of internal check with regard to cash transactions should possess the following characteristics:

- All incoming mail should be opened by persons other than the cashier or the clerk maintaining the Debtors' Leger. All receipts should be promptly recorded and acknowledged by way of pre-numbered money receipts, and heir- copies or counterfoils should be properly maintained.
- All cheques and postal orders should be crossed “Account payee only” immediately on receipt.
- There should be a daily reconciliation between the total cash credited to debtors, and the total of official receipts issued.
- Cash receipts should be *deposited* in the, bank on the same day and Bank Reconciliation Statements should be prepared at regular intervals by the cashier as also by someone *not* involved with cash receipts or records.
- The cashier should *not* have any responsibility or control as regards Sales Ledger, Creditor’s Ledger, Nominal Ledge, invoices, etc.
- Petty cash funds should be maintained as per the imp rest system and Petty Cash Register should be under the Supervision of a responsible official. All payments through Petty Cash Register should be properly authorised and there should be a maximum amount fixed for individual payments. In any case, the nature of these payments should be such that they cannot ordinarily be made by cheques. . '

- All payment, other than petty cash should be made by cheques. Cheques should be prepared only against authorized vouchers and the persons authorized to sign the cheques should not be involved with maintenance or cash payment records or with preparation of bank reconciliation statements. Cheques should be crossed “account payee only” and should be promptly dispatched to the parties concerned.
- Vouchers, against which cheques have been issued, should be cancelled so as to prevent their production in support of further cheques.

Review Questions

1) Explain the concept of internal control with its objectives and salient features.
2) Describe the advantages of Flow Chart.
3) State the features of internal check.
4) Describe the various steps in evaluation of internal control system.
5) Define vouching and explain its objectives.
6) “Voucher is the essence of Audit”-Discuss.
7) How would you vouch petty cash payments?
8) Explain the kinds of vouchers.

UNIT- III

LESSON-3

VERIFICATION OF ASSETS

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3.0 AIMS AND OBJECTIVES

This unit consists with various verification and valuation of various types of assets and liabilities in auditing. Here the depreciation auditing and different kinds of depreciations are discussed. Then audit of kinds of reserves and important judicial pronouncements on depreciation and reserves are discussed in detail.

3.1 INTRODUCTION

To verify means, to establish whether the actual facts or details are in agreement with those that are represented or asserted. Verification in the case of an audit is concerned with substantiation by means of physical examination, legal and official documents and expert opinion as to existence, ownership, possession, classification and valuation of assets and liabilities of the entity as disclosed in the Balance Sheet.

3.1.1 Mode and Object of Verification

The objectives of verification are achieved by proper combination of compliance and substantive audit procedures. Compliance procedures are aimed at ensuring that internal control as to authorization, processing and recording of transactions is being duly followed to prevent the risk of mis-statements in the financial statements. These will include examination of transactions and records based on conclusions drawn from internal control questionnaires and flow charts. Substantive audit procedures are aimed at detection of material mis-statements in account balances and transactions, and will include- (a) obtaining confirmation from third parties; (b) actual observation of assets; (c) testing reconciliation statements; (d) analysis of accounts; (e) vouching; (f) recompilation of figures to test clerical accuracy; (g) cut-off tests; (h) inquiries from officials of the client; (i) scanning of financial statements; and (j) examination of documents relevant to meetings of the Board, shareholders etc.

3.2 VERIFICATION OF ASSETS

According to the "Statement of Auditing Practices" issued by the Institute of Chartered Accountants of India (ICAI), the auditor's objective in regard to verification of assets generally is to satisfy himself that –

(a) they exist;

(b) they belong to the client;

(c) they are in possession of the client or any person authorized by him;

(d) they are not subject to undisclosed encumbrances or lien;

(e) they are stated in the Balance Sheet at proper amount in accordance with sound accounting principles; and

(f) thy are recorded in the accounts (this will include scrap and waste).

Accordingly, the objects of verification of assets is to form an opinion is respect of each of the following.

- **Existence of assets as at the date of the balance sheet.** The first step in process of verification is to see that the assets as disclosed in the Balance Sheet are actually in existence as on the balance sheet date. This can be done by physical inspection of all the assets or a representative sample thereof. According to the "Statement on Auditing Practices" issued by the ICAI, the auditor is not required physically to verify the assets. He can do so by applying appropriate substantive and compliance procedures, such as examination of available documentary evidence and evaluation of internal control. The statement explicitly states that it is the duty of the management of ensure that fixed assets of the enterprise are in existence and this should by physically verified by it at periodical intervals.

- **Ownership of assets.** Evidence as regards ownership of assets may be obtained by way of documents of title, e.g., papers containing evidence of ownership, such as contracts, certificates, etc. In case these documents are held by the enterprise, the auditor should insist that they be produced for audit inspection at the same time and not in bits and pieces such that these may not be pledged in respect of liabilities unknown to the auditor. Where the documents of title are held by third parties, the auditor should obtain a certificate directly from them or arrange to inspect the documents himself. In the case of assets without any documents of title, such as plant, machinery, furniture, debtors, stock-in-trade, work-in-progress, the auditor should design the verification procedure based on the efficacy of the internal control system of the enterprise.

- **Possession of assets, whether actual or constructive.** The auditor should ascertain that the assets are in the possession of the client. There are three requisites of possession. First, there must be actual or potential physical control. Secondly, physical control should be accompanied by intention to entrust possession. Thirdly, such intention should be visible or evidenced by external signs. Possession may be real, constructive or symbolic. If any asset is in possession of any other person, it should be seen that this has been duly authorized by the client.

- **Proper valuation of assets.** The auditor should ascertain whether all the assets are valued in accordance with the generally accepted accounting principles as determined by law, pronouncements issued by the Institute of Chartered Accountants of India (ICAI) and the International Federation of Accountants (IFAC), and prevailing practices. The policies as regards valuation should be consistently followed and the effect of any change in the valuation policy should be fully explained.

- **Proper presentation.** All material assets should be properly disclosed and described in the financial statements as required by law and the professional pronouncements of the ICAI and the IFAC. It may be that while an asset is properly disclosed in the Balance Sheet at the correct amount, the manner of its description may be misleading as, for example, loan to a small finance company being described as balance with bankers, such that anyone reading the financial statements will not have the faintest idea of the potential risk of a bad debt.

3.2.1 Distinction between confirmation and physical inspection

The objects of verification of assets are achieved by applying appropriate compliance and substantive audit procedure. Appropriateness of a particular procedure will depend on the auditor's conclusion based on evaluation of internal control system and evidence collected by him, for example, verification of certain assets and the liabilities may be performed by obtaining confirmation from the third parties, while in the case of others, physical verification by the auditor my be necessary.

Confirmation means affirmation by competent parties of certain facts and balance, For example, the auditor may secure written statements or certificates from debtors, banks, creditors, financial institutions, sister concerns, subsidiary companies, or brokers to assure himself that representation in the financial statements with regard to each of them has been truly and fairly made. Confirmation by an independent third party may be relied upon it such reliance, on the face of it, appears correct, as when the party concerned is ordinarily supposed to be in possession of the assets in question, or where it may ordinarily by involved in the type of transactions stated. For example, it is a usual practice for investments belonging to the client to be in the possession of his bankers or, pending completion of a transaction, with the brokers, however, if the investments are held by someone other than a banker or a broker, the auditor must take recourse to physical inspection of the assets.

The following items of the Balance sheet should be verified by means of confirmation:

(a) Sundry debtors, in the case of whom balances outstanding can be got confirmed by the panties concerned.

(b) Bank balances and shares and securities in possession of the bank, in the case of which confirmation may be obtained, form the principal officer of the bank.

(c) Assets held by foreign branches of the client, in the case of which confirmation by an independent auditor of the country concerned may be obtained.

(d) Prepaid expenses, such as rent, telephone charges, in the case of which confirmation by the landlord or telephone department may be obtained.

(e) Outstanding assets, such as accrued dividend or interest, in the case of which confirmation by the payer may be obtained.

Physical inspection of a tangible asset is with a view to establishing the physical existence of items in support of the recorded data concerning those items. But it is possible only in the case of items which have physical existence capable of being identified and which, moreover, are in physical possession of the client. It includes counting, weighing, and identification as also quality evaluation of the items concerned.

The items which require physical verification by the auditor may be –

(a) Land and building.

(b) Plant and machinery.

(c) Stock and stores

(d) Investments in possession of the client.

(e) Bills receivable.

(f) Cash in hand.

3.3 VERIFICATION OF LIABILITIES

Verifications of liabilities are necessary so as to form an opinion as to the truth and fairness of representation in the financial statements. According to the "Statement on Auditing Practice" issued by the ICAI, the auditors objective in regard to liabilities is generally to satisfy himself that –

(a) the credit balances appearing in the books are really liabilities

(b) liabilities not recorded, whether by accident or design, are brought into books,

(c) they are properly valued; and

(d) they are properly classified and disclosed.

Verification and Valuation

Assets	Liabilities
Fixed	
Floating or Current	External
Wasting	Internal
Intangible	
Fictions	

3.3.1 Types of liabilities

A liability is an economic obligation of a business that is recognized and measured in conformity with generally accepted accounting principles. Basic characteristics of a liability are: (a) it involves a future outlay of money or money's worth: (b) it arises from a past transaction; and (c) it is capable of being calculated or closely estimated.

- Current liabilities. They denote obligations the liquidation of which is expected to require the use of existing current assets or creation of other current liabilities. Examples of liabilities are: (a) trade liabilities, resulting from purchase of materials , including acceptances given; (b) deposits or advances received from customers, subscribers, etc; (c) accruals for obligations rising from business operations during the period under review, such as salaries and wages, rents, interest, and other operating expenses; (d) short-term loans and advances and installment payments as to long – term obligations; and (e) other accruals from operations even if these have to be estimated, such as, bonus payments to employees or obligations owed to persons not presently known, such as, guaranteed servicing or repairs.
- Long-term liabilities. The refer to obligations which are not expected to be discharged by (a) use of current assets; (b) creation of other current liabilities; (r) within a relatively short period of time, usually one year. They represent a formal commitment for the future of the business and are usually based on written agreements specifying is detail the lender's rights and the debtors obligations, such as, due date as to principal and interest payments, types of security provided, etc.

3.4 VALUATION OF ASSETS AND LIABILITIES

The auditor must satisfy himself that various assets and liabilities as disclosed in the Balance Sheet have been valued according to the generally accepted principles of accounting as determined by law, professional pronouncements and prevailing practices. He should also take into account factors such as- (a) obsolescence of assets due to change in economic conditions or increased competition; (b) technological changes; (c) governmental regulations as regards use of property; (d) replacement of relocation of assets; (e) decline in the usefulness of any asset due to inadequate maintenance; and (f) losses from business operations.

3.4.1 Accounting standard for valuation

- Valuation of fixed assets. A fixed asset may be defined as an asset which is held with the intention that it will be used for production or provision of goods and services and not for sale in the normal course of business. Accordingly, (a) they are carried over from year to year; (b) they are relative of higher rupee value; and (c) in inflationary market conditions, their book value is lower than their replacement value.

Fixed assets may be classified as (a) assets which are not subject to depreciation e.g., land; (b) assets which are subject to depreciation, e.g., building, plant and machinery; and (c) assets which are subject to depletion, e.g., mines, oil-wells, etc.

A non-depreciable fixed asset such as land is valued at cost price, including purchase price, broker's commission, registration fees legal fees an expenses on its conditioning such as clearing, draining, etc.

In case of depreciable fixed assets, the basis for valuation is the cost of purchase or construction, which includes all incidental payments necessary to put the assets in condition, e.g., freight, cost of materials, labour and services used in construction and installation, and title examination and registration fees. The cost is reduced by reasonable amount of depreciation. Any fluctuation in the price is to be ignored because the assets are not meant for resale and their usefulness to the business is not influenced by their market price.

The rates of depreciation should take into account – (a) expected physical wear and tear; (b) obsolescence; and (c) legal and other limits on the use of the asset. According to AS-6, "Depreciation Accounting", issued by the ICAI, the useful life of a depreciable asset may be shorter than its physical life. As such, though the rates of depreciation as regards a variety of assets have been given in Schedule XIV to the Companies Act, these should only be regarded as the minimum prescribed rates and a company may provide depreciation at a higher rate in case it deems it to be proper, and the auditor will have to accept such higher rate unless he considers it to be grossly incorrect.

- Valuation of floating or current or liquid assts. They refer to that group of assets which are in the form of cash and bank balances, including such other assets or reserves as are expected to be realized in cash, or sold or consumed within a period of not more than twelve months in the ordinary course of business. Stock-in-trade, amounts due from sundry debtors for sale of goods and the services rendered, advance tax payments, bills receivable, etc., are examples of such assets.

Sums credited to a provident fund, pension fund, gratuity fund, or any other fund for the welfare of employees, are not floating assets. Likewise, receivables arising from unusual transactions such as the sale of capital assets or loans or advances to affiliates, officers or

employees, are not floating assets as these are not expected to be collected within twelve months.

Book debts and bill receivable are generally valued at book value and in the case of the former, a provision is also made for bad and doubtful debts. Raw materials and semi-produced goods are valued at cost. In the case of closing stock, valuation at the Balance Sheet date is done at "lower of cost or market price", because, first, it prevents the taking into account of anticipated profits and likely distribution of dividends there from, as the same will be detrimental to business if profits do not materialize as anticipated. Secondly, it recognizes the probable loss of carrying value whether from change of style, shifting or market, deterioration, spoilage, or any other reason which may have direct relation to market price.

- **Valuation of wasting assets.** As asset that diminishes in value by reason of, and in proportion to, the extraction or removal of a natural product such as ores, oil, and timber, which it contains, is a wasting asset. Mines, collieries, oil-wells, etc., are examples of wasting assets. The value of such asset wastes away with use, rather than depreciating with time and use. The asset as such is irreplaceable and it has a useful life limited to the period over which it is economically feasible to extract the substance on which the value of the asset depends.

The cost of a wasting asset includes, in addition to the original cost of land, title cost as also exploration, development and carrying charges up to such time as commercial production begins. It is reduced by the amount of yearly depletion calculated on the basis of the total cost and the number of recoverable units.

- **Valuation of intangible assets.** An asset which does not have a concrete from and is not capable of being perceived especially by the sense of tough, is an intangible asset. But it is quite useful for the business and also realizable in cash. Goodwill, patents, copyrights, trade marks, etc., are examples of intangible assets. Valuation of intangible assets is done more or less in the same manner as fixed assets.

- **Valuation of fictitious assets.** An asset which, like an intangible asset, does not have concrete from but which, unlike it, is not realizable in cash, is a fictitious asset. In fact, a fictitious asset represents capitalization of expenditure which is essentially of a capital nature and the benefit of which is advertising expenses, expenses on issue of debentures and discount thereon, and development expenses, are examples of fictitious assets.

3.4.2 Meaning of important terms as to valuation

- **Meaning of cost.** It is the price for acquisition of an asset, whether by way of purchase or construction, and includes all incidental payments to put the assets at its place in condition, e.g., freight, cost of materials, labour and services used in construction and installation, title examination, and registration fees.

According to AS-10, "Accounting for Fixed Assets" issued by the ICAI, the cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies, and any directly attributable cost to bring the asset in working condition for its intended use. Any trade discounts or rebates are to be deducted in arriving at the purchase price.

Example of directly attributable costs are:

(a) site preparation

(b) initial delivery and handling costs;

(c) installation cost, such as special foundation for plant; and

(d) professional fees, e.g., fees of architects and engineers.

The cost of a fixed asset may be liable to change after its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties and similar other factors.

Ordinarily, administration and other overhead expenses are excluded from the cost of fixed assets because they cannot be attributed to any particular asset. However, where such expenses are specifically attributable, they can form part of the cost of the asset concerned. The expenditure incurred in respect of start-up or commissioning of the project, including the expenditure incurred on the test-runs and experimental production, is usually capitalized as an indirect element of construction cost. But expenditure relevant to the period subsequent to commencement of commercial production is not to be capitalized.

Meaning of "gross book value": According to AS-10, "Accounting for Fixed Assets", gross book value in the case of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

Sometimes, financial costs by way of interest etc., relating to deferred credits or borrowed funds and respect of construction of acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets, are also included in the gross book value of the asset concerned. However, such costs should not be capitalized in so far as they relate to the period after the asset is ready or has been put to use.

Meaning of "marked value": According to AS-10, "Accounting for Fixed Assets', fair market value in the case of a fixed asset means the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties, dealing at arm's length, who are fully informed and are not under any compulsion to transact.

Meaning of "cost of replacement": It is the value that would be required to be paid to purchase or produce an asset similar to the existing one.

Meaning of "break – up or scrap value": It is the price which an asset might be expected to realize of sold as scrap, being unserviceable.

Meaning of "going-concern value": It means the value of assets where the business is treated as a going concern, i.e., in actual operation and working order in which the transfer of ownership would effect no interruption of business. However, since it must take into account intangible assets, particularly goodwill, and also reflect overall earning capacity, it is difficult to apportion it properly to any particular asset of the business, except perhaps that it may serve as a special element in determining the market value of the asset. Going concern value is generally higher than the break –up value.

3.4.3 Auditor's position as regards valuation of assets

Accuracy or authenticity of financial statements is mainly dependent on the correctness of the valuation of business asset because otherwise the Balance Sheet will not truly and fairly present the financial position of the business and the Profit and Loss Account, the results of its operations. It is thus of paramount importance that before rendering his opinion of the financial statements, the auditor should fully assure himself that the values placed on the business assets are fair and reasonable and in accordance with the accepted commercial principles and statutory requirements, if any, and that they are not in any way influenced by (a) personal bias; (b) self-interest; (c) carelessness; or (d) dishonesty.

In Kingston Cotton Mills case, for the purpose of valuation of stock-in-trade, the auditor relied on the certificate of the factory manager who as was discovered later, was fraudulently manipulating the figures with a view to earning larger amounts of commission and boosting the business image. In the opinion of the Court, the auditor was justified in doing so. The auditor is not bound to approach his work with suspicion, or with a foregone conclusion that there is something wrong, and it would be unjust to make him liable for not tracing out ingenious and carefully –laid schemes of fraud perpetrated by tried servants of the company, who even the directors were unable to detect for such long.

However, the auditor's responsibility as to valuation of assets does not end with merely securing certificate of valuation from experts, including officials of client. He has a duty to take all reasonable steps and exercise due care to ensure that the value of assets as shown in the certificate does indeed represent a true and fair value. Hence, he is required to ascertain – (a) that the valuation has been done in conformity with legal and professional standards as to generally accepted principles of accounting; and (b) that the principles and practices governing valuation of assets have been consistently followed.

If he does not exercise due care and skill in the matter or valuation, or if he falsely represents that he has performed the necessary operations in connection therewith, he may be held guilty of negligence, and liable for damages. In Leed's Estate Building and Investment v.Shepherd (L.R.36 Ch D.787), the auditor was held liable as to dividends paid

out of capital for several years, based on financial statements which erroneously showed a profit, while the company was in fact incurring losses.

To conclude, the auditor may be held liable for incorrect valuation if it is established that the matter was within his special field of competence, and that there was failure on his part to exercise the quality of judgment reasonably associated with a person in a skilled profession.

Revaluation of fixed assets: Though there is no consensus on the question of providing funds for the replacement of fixed assets, the auditor should advise the client to do so either by periodic revaluation of fixed assets or by setting aside appropriate sums out of profits to reserves specifically created for the purpose.

A revaluation means a revision of the book value of capital assets in accordance with proper appraisal of such assets. Appraisal for this purpose will mean establishment of proper values by a systematic procedure, which may include physical examination or ascertaining the condition of each unit of the plant, engineering estimates of future working life and the possibility of obsolescence. An appraisal is usually made by independent and qualified persons such as engineers, architects, etc. The auditor may after due examination rely on and accept the revaluation made by the experts.

If a company revalues its assets and shown the same in the Balance Sheet at their replacement cost, depreciation in respect of such assets should provided on the basis of the revalued costs. However, any reserve created on revaluation should not be used for distribution as dividend as revaluation by itself does not create any funds. Only provision of increased depreciation on the revalued cost will result in creation of funds to be utilized for replacement of the assets concerned.

3.5 VERIFICATION OF INDIVIDUAL ASSETS

Freehold land

A freehold property has two main features, e.g., immobility and an indeterminate duration. Verification of freehold land will include a careful inspection of the title deed, conveyance or purchase deed. To establish its genuineness, a certificate from the client's legal adviser may also be obtained. In case the ownership documents are with the legal adviser or banker, a certificate from the person concerned should be inspected. If there has been purchase of freehold and during the year, the purchase contract along with relevant vouchers such as assessment notices, tax bills, and any correspondence on the subject should be examined. In the case of sale of any freehold land during the year, the sale deed along with all related vouchers and correspondence should be verified.

An important point to note is that freehold land should be separately shown in the Balance sheet and not bracketed with any other asset, whether freehold or leasehold.

Valuation: Being a non-depreciable asset, freehold land is generally shown at cost, which includes the purchase price, cost of options, unpaid taxes assumed, broker's commission, registration fees, legal charges, and also clearing, draining and other similar expenses. If payments have been made to the municipality for laying of water mains or sewers, these may also be included in Improvement Account, the same being subject to depreciation. In case market or realizable value is taken as the basis for valuation of freehold land, the same should be clearly disclosed in the Balance Sheet.

Lease –hold land

Lease – hold land means tenancy of an immovable property held on lease, which implies a transfer of a right to enjoy such property for a certain period or in perpetuity, in consideration of price.

Lease – hold land should be verified by inspection of the original lease. If it is in the name of a person other than the client, the auditor should inspect the letter confirming the arrangement. It should be ensured that the lease is registered with the Register and the conditions stipulated therein with regard to the payment of lease-rent, maintenance, etc., are duly fulfilled because failure in this respect may result in its cancellation. Lease – hold land is not liable to be mortgaged. But it may be sub-let, in which case arrangement with the sub-tenant should be verified.

Valuation: The cost of lease – hold land should be verified by reference to the letter from the legal adviser and other relevant documents. Unlike freehold land, lease-hold land is subject to diminution in value with passage of time, and as such depreciation should be provided thereon at a rate that is adequate to write off the total cost over the lease – period.

Buildings

To verify buildings, the auditor should inspect the title deeds, but he should ensure that the validity of the deeds has been certified by the client's legal adviser. In case the property has been mortgaged, the title deeds will be in possession of the mortgagee, in which case an acknowledgement of this fact should be obtained from him or his legal advisor, together with particulars of the amount due. If the property is subject to a second mortgage, the title deeds will be in possession of the first mortgagee, but it should be seen that he has due notice of creation of the second mortgage. Where the title deeds are in possession of a legal adviser or banker, a written declaration should be obtained from the custodian whether these are held for safe custody only, or in connection with a mortgage or charge.

Buildings owned by the client may have been either purchased or constructed during the year under audit. In the case of purchase, the auditor should vouch the payment and ensure that the Buildings Account has been appropriately debited with the capitalized cost

such as purchase price, expenditure for repairs to place the building in working condition, cost f alteration, improvements and remodeling, unpaid taxes assumed, and legal and registration fees. He should also see that the conveyance deed has been registered with the Registrar and a certificate as to validity of the deed has been secured from the client's legal adviser.

In the case of construction of building, the auditor should examine bills from the contractor and architect and certificate from the latter. He should ensure that architect's and engineers fees cost of materials, labour, temporary structures constructed fro site office or for storing material and tools, and premiums on casualty policies and other allocable overheads are appropriately capitalized by a debit to the Buildings Account.

Where the buildings are situated on freehold land, separate accounts should be maintained for buildings and land because while the former are a depreciable asset, the latter is not. To this end, the client should be asked to procure a certificate from a valuer or an architect testifying to the value of each.

Valuation: Buildings should always be valued at cost less depreciation at a reasonable rate. Depreciation should be provided even where the buildings have not been used during the year and the argument that the market or realizable value is higher than the cost and therefore a provision for depreciation may be dispensed with is not valid.

In any case, market or realizable value, which is subject to frequent fluctuations, should not be taken into account while valuing the buildings. But where it is used as a basis of valuation, it should be clearly disclosed in the Balance Sheet.

Lease – hold buildings

Lease-hold buildings should be verified by an inspection of the lease agreement. Where the lease is in favour of a person other than the client, a latter confirming the arrangement should be obtained from the nominee. The auditor should see that lease agreement is registered with the Registrar and certificate testifying to validity of the same has been secured from the client's legal adviser. The amount of lease money, together with all incidental expenses as to acquisition of the lease, should be appropriately capitalized by a debit to the Lease – hold Buildings Account. It should also be ensured that the conditions stipulated in the agreement with regard to payment of lease –rent, maintenance, fire insurance, etc. are being duly complied with.

Valuation: Lease – hold buildings should be valued at cost les depreciation, which should be at a rate that is sufficient to write it off completely during the period of the lease.

Ownership flats

If flats or premises are acquired on ownership basis, the same should be verified by reference to the amounts paid for the same, including the shares, if any, in the co-operative housing society or company which has made the allotment. Such flats or premises should

be shown under “Fixed assets” liable to depreciation. Sometimes, under the rules of the society or company, the flats or premises may be registered in the names of individual members. If so, letters should be obtained from the individuals concerned to the effect that they are only trustees, and do not have any other right, title or interest in the properties.

According to the statement on Auditing Practices” issued by the ICAI, premises may also be acquired by way of purchase of shares or debentures in joint stock companies. Whether such investments should be shown under “Fixed assets” or “Investments” would depend upon the circumstances of the case, and in each such case the substance of the transaction should be more important. In the case of a public company, such investment in shares would be subject to the provisions of Sec.372.

Valuation: Ownership flats or premises, being depreciable assets, should be shown at cost less depreciation, together with the cost of the shares.

Jointly owned assets

If a company owns any assets jointly with others (not as partner in a firm), the extent of its share in such assets, proportionate original cost and accumulated depreciation and written down value should be stated in the Balance Sheet, Alternately, the pro rata cost of such assets may be grouped together with similar fully owned assets. Details of jointly owned assets be shown separately in the register of fixed assets.

Basket purchases

If a single consolidated price has been paid for a number of assets, the price should be apportioned over the individual assets in the ratio of market value of each asset on the date of purchase. The assessment of market value should be made by expert valuers.

Plant and machinery

These should be verified by personal inspection and with reference to the original documents which served as the basis for entries in the books, such as purchase orders, venders’ invoices, contracts, requisitions, construction reports, etc. Plant Register, which is generally maintained by big concerns to keep a detailed record of plant and machinery, such as, the following, should be carefully inspected.

- Name and description of the machine.
- Number of the machine (for easy identification).
- Location of plant.
- From whom purchased.
- Date of installation.
- Purchase price.

- Cost of installation and other items of expenditure to be capitalized.
- Estimated life.
- Rate and the method of depreciation.
- Amount of depreciation provision.
- Repair information, such as date, cost and nature.
- Other information concerning the plant and machinery.

The auditor should ensure that the invoice, freight, duty, and unloading charges paid in regard to the purchase of plant and machinery are duly capitalized. Where these are constructed by the client, the same general principles relating to capitalization of materials, labour, allocable overheads and other costs should be applied as in the case of buildings. Installation costs and other charges incurred to place the asset in condition for use, should also be capitalized, irrespective of whether it has been purchased or constructed.

Purchase on deferred payment plan. Where plant and machinery are acquired under hire purchase or other similar agreement, the auditor should examine the relevant contract, invoices, etc. to ascertain the method of payment, date when the title is to pass, and so on. The gross purchase price in such a case should usually include interest, but only the net cash purchase price should be capitalized, the interest being chargeable to a separate revenue account. Further, the total purchase price less any down payment, should be shown as a liability at the time of acquisition, and depreciation should be shown on the entire asset cost, and not merely with respect to the aggregate of paid amounts.

Valuation: Plant and machinery are generally valued at the original cost less depreciation at a reasonable rate to be calculated according to an accepted method which should be disclosed in the accounts. Necessary, adjustments in respect of additions to the existing plant and machinery, or sales there from should be appropriately made. Repairs and renewals of a routine nature should be charged to a separate revenue account for repairs and maintenance.

Market or realizable value of plant and machinery, which is subject to fluctuations, are generally not considered for the purpose of valuation. But where it is decided to take it as the basis, the auditor should examine the Valuation Sheets carefully and have the basis of valuation clearly disclosed in the Balance Sheet.

In any case, valuation of such an important asset should be done by an expert valuer, though it will be wrong to accept his certificate without a reasonable investigation on the part of the auditor.

Furniture, fixtures and office equipment

Furniture refers to movable articles in a dwelling house or a place of business. Fixtures mean chattels so affixed to land or building as to become a part thereof. Office equipment means office appliances. The assets which are included in this category are desks, chairs, show cases, counters, shelves, partitions, display fixtures, carpeting, typewriters, accounting machines, computers and other similar items.

Verification of these assets include inspection of original purchase invoices and fixed Assets Register, containing name and description of each asset, location, name of supplier, date of purchase, estimated life, estimated scrap value, depreciation rate, and repair information.

Valuation: Furniture, fixture, etc are valued at cost less depreciation at a reasonable rate. Care should be taken to see that provision of depreciation is adequate, keeping in view the working life of the asset which, given a variety of items of be found in this category, will be different in the case of different assets.

Transportation equipment

Transportation equipment may consist of trucks of various sizes, trailers, station wagons and small buses used for pick-up and delivery of goods, and for transporting employees.

Verification procedure relating to transportation equipment will by and large be the same as in the case of plant and machinery. If a Vehicle Register, on the same lines as the Plant Register, is maintained by the company, the auditor should carefully go through the entries with regard to each vehicle and ensure that the particulars as to registration number, type, etc. tally with those given in the registration book for each vehicle. In case a vehicle is registered in the name of a person other than the client, the auditor should inspect the letter confirming the arrangement and ascertain that there is no charge on the vehicle in favour of such person. Usually, transportation equipment is insured against theft, damage and liability, and the information contained in the insurance policies regarding ownership and identification of the vehicles can also be used to verify particulars in the Vehicles Register.

Valuation: Transportation vehicle, though movable assets, are regarded as fixed assets because these are used for carrying on the business. For this reason, these are to be valued at cost less depreciation. Cost includes the purchase price of the chassis, body of the vehicle and other accessories, if any. But insurance premium, if any, paid at the time of the purchase should not be capitalized. Provision of depreciation should be adequate and for this purpose depreciation ought to be calculated with reference to the distance in kilometers covered by a vehicle in the year as against the mileage which it is expected to run during its life-time. To this end, the auditor should ensure that Speedo-meters are in working order and the readings are noted by responsible officials.

Patterns, drawing and dies

Patterns, drawings and dies are often numerically large and of varied sizes, and there is a risk of their being lost, mislaid or stolen. As such, these should be verified from the inventory sheets prepared at the time of annual stock-taking by a responsible official.

Valuation: Generally, these assets are valued at cost less depreciation calculated with reference to the estimated wear and tear. But this can be only in respect of assets which are purchased or constructed to be used for regular production. Thus, where these are required for special jobs, their residual value will be negligible and in such a case their entire value should be charged to the special jobs, Similarly, where production of a model ceases because of obsolescence or improvement, the patterns, dies, etc. relating to that model will become worthless and their values should be completely written off, In any case, because of the very limited life expectancy of such assets, a rapid rate of depreciation should be used and their entire value should be written off latest in 3-4 years time.

Patents and trade marks

A patent is an official document which secures to the inventor an exclusive right for a term of years to make use or sell his invention a trade mark is a distinctive mark attached to goods offered for sale in the market so as to distinguish the same from similar goods and to identify them with a particular trader, or with his successor as owner of the particular business.

Verification of patents should be made by inspecting the certificates conferring patent rights. In case the patents are large in number, a Schedule of Patents should be prepared giving details, such as, the registration number, date, patented item, renewal date, etc., concerning each patent. In case a patent has been purchased, the Assignment Deed should be carefully scrutinized.

Trade marks should be verified with reference to the certificate issued by the Patent Officer along with the receipt of renewal, to ensure that it has not lapsed. Correspondence with the patents and trade marks agents should also be gone through to see whether there have been any changes therein. Patents and trade marks registered in foreign countries might present some difficulty in their verification because, in their case, the amount of registration fees outstanding on the date of making up of accounts will have to be ascertained.

As the amount of patents and trade marks is required to be separately shown in the Balance Sheet of a limited company, the auditor must ensure that this provision is duly complied with.

Valuation: Patents and trade marks should be shown at cost less depreciation, which should be calculated with reference to the period of expected benefit, but in no case more

than the life of the patent or trade mark which is usually 16 years or an extension thereof, if any. Moreover because these are subject to obsolescence, there should be a careful review of each item for evaluating its usefulness and retention in the books. While doing so, expectations of management as to productive period of a patent or trade mark, market studies, sales forecasts and profit projections, should be given due weight age.

Copyrights

A copyright is the exclusive legal right to reproduce, publish and sell the matter and form of a literary, musical or artistic work.

Verification of copyrights should be with reference to original agreements and correspondence and other supporting evidence. Where a copyright has been purchased, the price paid should be verified from the written assignment. However, where the client himself happens to be the author of the copyrighted work, there may not be any documents of title for inspection, and no value of such work should be shown in the books.

Valuation: Generally, a copyright is shown at cost less the amounts written off as depreciation from time to time. The rate of depreciation should be based on calculation as to the period of expected substantial sales of the copyrighted work. Thus, in the case of copyright on a highly topical book, the entire cost should be written off over a relatively short period during which the sales of the book are expected to be active, and not over the full 14 year legal life of the copyright. Even where a reasonable writing off period has been determined at the outset, it may have to be curtailed on case there is apprehension of reduction in the future benefit because of obsolescence or other factors.

To sum up, periodical revaluation of a copyright seems to be the only satisfactory method of representing it in the books of account.

Goodwill

Goodwill of a business is an intangible asset and includes every advantage that has been acquired in carrying on the business, whether connected with the premises, or its name or style, and everything connected with or carrying with it for the benefit of the business. According to the “Statement on Auditing Practices” issued by the ICAI, goodwill is generally recorded in the books only when some consideration in money or money’s worth has been paid for it.

According to AS-10, “Accounting for Fixed Assets” issued by ICAI, if goodwill has been purchased along with a running business, the same should be verified from the agreement with the vendors showing the price paid for it. Where the price of goodwill has not been specifically fixed, it is determined as equal to the difference between (a) the total purchase price paid and (b) agreed valuation of the assets acquired. Where goodwill is generated in own business, it is verified from particulars of expenses debited to Goodwill Account,

though such practice should be actively discouraged because it may be used by an unscrupulous management to capitalize revenue expenses, debitable to the Profit and Loss Account, so as to inflate current profits.

Valuation: As a matter of financial prudence, goodwill is written off over a period by appropriation of profits, though there is no consensus of opinion on this subject and an enterprise may not write it off. Goodwill should be valued at cost less the amounts written off. The auditor must satisfy himself that the future benefits as associated with goodwill do in fact exist to justify the continuation of Goodwill Account. If it appears to him that such benefit is non-existent or illusory, he should insist on the account being written off. Else, he should qualify his report accordingly or refuse to give his opinion if the amount involved is substantial.

However, if the auditor is satisfied as to the genuineness of expenditure debited to Goodwill Account, he should carefully ascertain the period over which the amount should be written off. In any case, due to frequent fluctuations, the real value of goodwill may not always be equal to its book value on the date of Balance Sheet. But then, it is no part of an auditor's duty to determine its realizable value.

Investments

According to the "Statement of Auditing Practices" issued by the ICAI, the auditor is required to satisfy himself as regards the powers of the enterprise under audit to make investments, by examining the documents such as the Memorandum of Association in the case of company. It should also be seen that legal requirements as regards investments as laid down in Sec.292 (Board's power to invest the funds of the company), Sec. 293 (restrictions on Board's powers to invest otherwise than in trust securities), and Sec.372 (limit up to which the company may purchase shares, etc. of other companies) of the Companies Act, are duly complied with.

Investment may be classified as marketable securities consisting of corporate shares, debentures, bonds and government securities, and long-term investments consisting of marketable securities intended to be held on a long term basis, shares of subsidiaries and advances to them, non-operating real estate, and other investments held for income or appreciation in value. Of these, marketable securities are readily saleable, but long-term investments which are held with no likely intention to sell, are not so.

The object of verification of investments is to ascertain that (a) there is valid evidence of their ownership and custody; (b) they are properly classified in financial statements as current and long-term; (c) there is adequate disclosure of any pledging, hypothecation, collateral or any other matter having a bearing on the value of investments, or on the client's unilateral right to dispose them off; and (d) these are valued on a basis in accordance with legal and professional standards as to generally accepted accounting principles, consistently applied.

Investments should be verified by reference to the Schedule of Investments, which should be prepared particularly where the number of investments is substantial, and the Register of Investment required to be maintained under Sec.372(6) of the Companies Act.

The Schedule should give particulars as the date of purchase, name of security, cost, market price, date of receipt or accrual of interest or dividend, and these should be tallied with the Investment Register.

Verification of Government and trust securities: The auditor should inspect the Broker's Contract Note, the bill and the money receipt and ascertain that the investments are held in the name of the client or his nominee, in which case the letter confirming the arrangement should also be seen. Where investments are kept in the custody of bankers, a certificate to that effect should be secured which should make a special mention of their status as custodian, lien or charge-holder, etc. Securities held by the client should be physically verified, preferably at a single sitting.

Verification of shares, debentures and bonds of companies: The auditor should confirm by reference to the relevant documents (Memorandum / Deed) that the client has power to invest money in shares, debentures, etc. of other companies. The authority to purchase or sell the securities should also be verified from the relevant papers such as minutes of the meetings of the Board / partners, etc. In the case of a company, the requirements of Secs.49 and 372 with regard to maintenance of Investment Register should be duly complied with.

All investments should be held in the name of the client. If they are held in the name of his nominee, the letter confirming the arrangement should be examined. Sec.49(5)(aa) permits a company to hold shares in the name of its bankers and if such be the case, the auditor should verify the Banker's Contract Note, the bill and money receipt concerning the transaction.

Investments in possession of the client should be physically verified with reference to the Schedule and Register of Investments. Preferably, this should be completed on the last day of the year at a single sitting. In case investments are kept in the custody of others, say a banker, and then a certificate to that effect from the party concerned should be obtained, clearly specifying whether these are held for custody only, or as a lien or charge against a liability. Holding of investments by share brokers is not to be allowed, except where it is in connection with a proposed transfer.

Where any investments are purchased or acquired during the year, the letters of allotment along with the Broker's Bought Note should be verified. In case the investments are quoted at any stock exchange, care should be taken to ascertain that their purchase is at the rate quoted on the date of purchase. The payee's receipt of the amount paid should also be inspected. Sec. 108 of the Companies Act, which seeks to curb abuses in the system of blank transfer, prescribes a period within which shares held under blank transfer must be registered. Special care should be taken no see that this provision is not violated.

Likewise, in the case of sale of Sec.227(1A)(c), dealing with sale of shares at a price below the purchase price, are fully complied with.

Shares and debentures of a subsidiary company: Sec.49(3) permits a company to hold shares in its subsidiaries in the name of any nominee. While verifying such securities, the auditor should verify particulars relating to – (a) class of shares or debentures held; (b) date of purchase; (c) cost and book value; and (d) date of receipt or accrual of interest or dividend. As far as possible, there should be personal inspection of such securities. In case these are held by others, e.g., bankers, a certificate from them should be verified. It should also be seen that diminution in the value of securities has been duly provided for.

Bonus shares: If bonus shares are received by company in respect of its holdings in another company, the correct accounting treatment would be only to increase the number of shares held by the number of bonus shares received, without making any entry in the value column. Consequently, there will be reduction in the average rate at which the shares are carried in the books of the company.

Rights Shares: If the company subscribes to the offer of rights shares, the cost of the rights shares should be added to the value of original holdings. On the other hand, if the rights shares are not subscribed but sold in the market, the resulting profit will be capital gain and this may be shown in the Profit and Loss Account if the Memorandum and Articles of the company do not prohibit such practice. If the market value of the original holding has fallen below its cost the sale proceeds of rights shares may also be applied to reduce the cost of the original holdings.

Investment in real estate: They should be verified in the same way as fixed assets of the client. But these are to be distinguished from other fixed assets, as they represent investment for income or appreciation in value, such as ownership flats acquired through membership of a society or company. In such a case, a question may arise whether these should be shown in the Balance Sheet under "Fixed Assets" or "Investments." However, as stated by the Research Committee of the Institute of Chartered Accountants of India in its "Statement of Auditing Practices", what is important in this case is not the form, but the substance of the transaction and, as such, the issue should be decided on the basis of facts and circumstances of each case.

Valuation: Investments are generally to be valued at cost which includes brokerage and stamp duty paid with regard thereto. But this is to be done when they are held as a fixed asset for the purpose of earning interest or dividend, as in the case of a trust. The assumption is that investments held as such do not suffer any depreciation, except where they are in the form of shares in mining or plantation undertakings, though even in that case the purpose of holding the investments will have a vital bearing on their valuation.

However, investments held as a current asset should be valued at cost or market price, whichever is lower. Market value of quoted investments should be official lists of the stock exchange. In the case of unquoted investments, the auditor should examine the

financial statements of the company concerned, and also seek information as to the price at which the latest share transfers have been registered. Better still, he should himself compute the value on dividend-yield basis as compared to other similar concerns.

Verification and valuation of investments: Some issues

While verifying and valuing investments, the auditor should be particular attention to the legal requirements as laid down in Secs.292, 293(1)(c) and 372 of the Companies Act. According to Sec.292, the power to invest the funds of a company can only be exercised by the Board at its meeting, or by the persons authorized by the Board in this behalf. Sec.293(1) (c) places restrictions on the power of the Board to invest (otherwise than in trust securities) the amount of compensation received by the company in respect of compulsory acquisition of any undertaking owned by the company. As per Sec.372, particulars relating to all investments made by the company should be entered in the Register of Investments.

As per the judgment in City Equitable Fire Insurance Co, Ltd. case, it is the duty of the company's auditor to satisfy him that the securities held by the company do in fact exist, and that they are in safe custody. To this end, the auditor should, as far as practicable, personally inspect the securities irrespective of the standing and character of the person in whose possession the securities are stated to be, e.g., director, partner, senior executive of the company, etc. He should not blindly accept a declaration from these persons to the effect that the securities are being actually held by them. Because, there can be instances where they may have sold or otherwise disposed of such holdings for personal gain. In any case, company's brokers are not the proper people to have custody of its securities, not with standing their standing in the market.

As regards valuation, the auditor may find that the market value is much below the cost of acquisition of investments. Ordinarily, he should ignore a temporary fall in the market value, particularly when the investments are held as permanent assets. But if the fall in value appears to be a lasting nature, he should see that adequate depreciation in provided by debiting the Profit and Loss Account and crediting the Investment Account. Where he is unable to determine the value of any investments, he should fully disclose the known facts regarding this and qualify his report appropriately. Where investments are held in a company which has not been able to show profits, the auditor should follow the principle of providing for anticipated losses and ensure that an adequate provision is made for a possible loss. In case there is apprehension of a fall in the value of investments after the balance sheet date, though the company has no immediate plans to dispose of the investments, the auditor should state that the value disclosed in the financial statements is 'subject to the future realization of investments."

Inventories (Stocks)

Inventories consist of owned items that are carried for sale or use in the production of goods and services. They may be categorized as raw materials, work in-progress, finished products, and materials to be used indirectly in production or related activities.

According to the "Statement on Auditing Practices" issued by the ICAI, the object of verification of inventories is – (a) to ascertain that, as far as practicable, proper care has been taken in determining the physical quantities and their condition; (b) to ensure that the client owns the goods and that any lien or pledging of the goods is disclosed in the financial statements; and (c) to assure that the quantities have been fairly and consistently priced in accordance with accepted accounting principles and that due provision has been made for possible losses and defective and obsolete goods are not shown in the statements except at a fair value.

3.6 INVENTORY VERIFICATION PROCEDURE

As inventories constitute the single most important item affecting the results of operations of an enterprise and its financial condition, the auditor should be especially alert to the possibility of risk of mis-statement in financial statements due to – (a) geographical dispersal of inventories creating problems of physically verifying and valuing them as on the balance sheet date; (b) difficulty in identifying and measuring items such as work-in progress; (c) obsolescence of inventory items leading to faulty valuation; (d) faulty methods of allocation of overheads in valuation; (e) mistakes in recording and pricing of inventories; (f) inclusion of sold goods in the closing stock; and (g) other clerical mistakes. The auditor should examine the system of internal control to ascertain if there is effective segregation of responsibilities for custody and accounting of stock-in-trade, and that there are adequate checks on over – stocking, spoilage, obsolescence, and fraudulent loss through theft and embezzlement.

- He should secure a copy of the client's physical inventory verification instruction in advance of the actual verification, and see whether these contain adequate safeguards possible errors and fraud.
- He should obtain copies of physical lay-outs all plants, giving names and description of all departments where inventory is held, as also names of the persons in-charge, so as to satisfy himself that verification operations cover all areas. Details as to quantity and value of inventory with each department at the time of last stock taking, should also be obtained for comparison with the current years data.
- He should satisfy himself that proper and adequate records of inventories have been maintained by the client, and proper cut-off arrangements made, such that goods sold not dispatched are excluded from inventories, all purchase invoices are included irrespective of the place where the goods covered by them are situated and, in the case of physical inventory verification being at a date other than the balance sheet date, movements of goods in and out of the establishment, are properly added or deducted as required.

- He should ascertain that the personnel deployed for verification are reasonable competent, have enough time to devote to the work, and are not concerned with the custody or record of inventories.
- He should ensure that methods prescribed in the management instructions regarding counting, weighing and measuring of inventors are duly adhered to.
- He should see that items of a capital nature, those not related to the clients business, and those held by the client on others behalf are duly excluded from inventories.
- He should test check the physical existence of at least 5% of the items to ascertain whether inventory records do correctly represent the stock-in-hand. To this end, he should pick up certain bins, stacks or piles materials and check their description, quantity and other data on the count- tags attached to them.
- He should inspect the original verification sheets to ascertain whether they cover all the items of inventory and trace a selected number of items, particularly the more valuable ones, to the final stock. Any difference between the physical count and inventory record should be investigated and suitable adjustments made in the records.
- He should see that inventory lying with the third parties, such as fabricators or consignees, are included in the inventory –sheets. As regards goods sent for fabrication, the points to be noted are : (a) the material goes out in one form and comes back in another, (b) the quantity going out may not be received back in full, whether due to the natural wastage or scrap; and (c) the material going out may be returned with certain other materials. As for the goods sent on consignment, it should be ensured that these are not counted twice.
- Wherever practicable, he should attend the inventory verification as least for a part of the time and see that the staff deployed for the work is discharging its duties efficiently. A measure of such supervision is necessary because most of the staff members assigned this duty belong to junior ranks, and are not quite familiar with inventory methods. Where major items of inventory are located at places not generally visited by the auditor, there should be a system of visit by the auditor by rotation.
- He should work out the ratio between gross profits and sales, and compare it with that of the past year. Any material difference between the two should be properly investigated.
- He should see that inventory is valued “at lower of cost or market price.” Cost should be further defined as average, FIFO, LIFO, etc. Market price generally means the current replacement cost by purchase or by production. In this connection, the auditor should ascertain if the client has established an adequate system for determining the cost of the sock-in-hand, such as – (a) whether all costs and appropriate overheads includibel in inventory valuation are properly recorded;(b) whether cost records are revised periodically to ascertain the lest cost; and (c) whether the system pinpoints cost variances, such as, material price and usage variance, overhead absorption variance, etc.

- Method of inventory verification. Inventory verification work should be properly planned. The staff on verification duty should be given detailed instructions in advance regarding what work is to be done by each of them, where and with whom.

Generally, personnel on verification duty are divided into two groups; (a) counters, who physically count, weight or measure the goods; and (b) checkers, who record the results of the physical count on specially designed sheets called stock-sheets. The stock-sheets are then priced, extended and added by the administrative staff and each sheet is signed by a responsible official.

3.6.1 Important points as to inventory verification:

Inevitably, a large part of inventory verification is done by members of the staff of the client and the auditor cannot be expected to count more than a small percentage of the items. However, the auditor should take the following precautions to ensure that inventory verification is free of errors and fraud.

- Purchase which have been dispatched form the vendors premises prior to the verification date and included in the inventory records, though not actually received, should be included in the inventory sheets. Conversely, goods actually received though not entered in the record due to non-receipt of supporting invoices, should be excluded.
- Goods held by own branches, agents, or sent to customers on “sale or return” basis should be included in the inventory records.
- Goods sold and entered in the inventory records as such, thought not despatched to the buyers, should be excluded from the inventory –sheets.
- The store –keeper should have nor role in the verification in his own area. Likewise, verification of piece-work items or those on which group bonus is payable, should not be done by persons who stand to benefit from such payments. It should be ensured that the staff is wholly independent and that there is not basic conflict of purpose in their assignment.
- According to the “Statement of Auditing Practices issued by the ICAI, verification of inventory by physical count is primarily the duty of the management and the auditor is entitled to rely on the stock records as prepared and certified by the management. In conformity with this, the auditor should secure a certificate from the management, declaring, inter alia, that – (a) the quantity, description, and value in the inventory sheets as on a particular date, are correct to the best of their knowledge and belief; (b) the inventory included in the inventory sheet is the property of the client; (c) the inventory sheet show only such goods as are represented in the inventory records; (d) no part of the goods shown in the inventory sheets includes goods sold but not delivered, or goods received from vendors but not entered in the records. (e) losses on account of obsolete or slow moving goods have been either wholly written off or appropriately proved for ; and (f) the same method of valuation of inventory has been consistently followed in the past years.

Must auditor be present at inventory verification? Inventory verification should logically fall under the general supervision of the management as it is most vitally interested in the accuracy of the financial statements of the enterprise. The "statement on Auditing Practices" issued by the ICAI, is also in accord with this view. The auditor is not professionally qualified to do so on account of lack of technical knowledge and, secondly, because he may not have adequate staff for the purpose. Therefore, he is entitled to place reliance on the records of the client and the certificate as to the quantity and value inventory as issued by the management.

But this is not to say that the auditor has absolutely no responsibility as to physical verification of inventory. He is expected to exercise reasonable care and skill to ascertain whether the procedure of physical verification as laid down by the management is such as would enable it to issue such a certificates, and further that the employees engaged in physical verification have been scrupulously observing the said procedure.

To satisfy him self on this count, the auditor's presence at physical verification becomes necessary and desirable, if not on a regular basis, then at least once in a while. But if he is aware of any irregularities in the stock is a material item, then it might be risky for him to keep away form physical verification. For, if due to his absence, any fraud or error goes undetected, he may be held liable for not exercising due care and skill in the performance of his duties.

3.6.2 Valuation of Inventories

According to the "Statement on Auditing Practices" issued by the ICAI, the basis on which inventories are valued is determined by the management. The normal basis on which inventories are valued is determined by the management. The normal basis is cost or net realizable value, whichever is lower. For this purpose, cost is to arrived at by taking the aggregate of costs of purchase, costs of conversion and other costs incurred in bringing the inventories to the present location and condition. The net realizable value is the estimated selling price in the ordinary course of business, less costs of completion and costs necessarily to be incurred in order to make the sale.

The method of valuation, based on purely arbitrary write – off that is not justified by estimates of marketability cannot be considered as an acceptable basis of valuation. In appropriate circumstances, having regard to the industry, e.g., plantation, inventories may be valued at market value or at prices subsequently realized.

The Institute of Chartered Accountants of India has accepted the obligation of enforcing International Accounting Standards in respect of inventory valuation. However, implementation of these Standards in India has been postponed for the time being. IAS-2, "Valuation and Presentation of Inventories in the case of Historical Cost System" will have to be complied with as from the date on which the Institute decides to implement it. The auditor is expected to bring this to the notice of his clients.

However, for valuation at lower of cost or market price, a clear understanding of the terms "cost" or "market price" as also the methods of valuation is essential. It also requires the auditor to ascertain whether the client has an adequate system for determining the cost of inventories, and whether all costs properly includible in the valuation have been taken into account.

Raw materials: They are required for manufacture of goods and not for resale. Therefore, they should always be valued at cost, i.e., net invoice price plus a reasonable proportion of the expenses connected therewith, such as, freight, duty, etc. To this end, where it is possible to distinguish the materials consignment –wise, the net invoice price paid in respect of each consignment should serve as the basis of valuation of materials remaining unused there from. Where materials purchased in different lots have been indistinguishably mixed up, the weighted average price should be the basis for valuation.

But in no case should raw materials be valued at a price higher than the market price. In case of any fall in the value of materials, the loss should be adequately provided for. Likewise, when there is any fall in the value of the finished goods in which such raw materials are used, it should be seen whether the cost together with manufacturing expenses would be fully realized. In the case of any shortfall, the loss in value of raw materials should be written off.

Certain raw materials, such as, wine, tobacco, generally register an increase in value with the passage of time. These may be valued at a price higher than their cost, provided such valuation seems reasonable in view of the totality of circumstances, e.g., market price of identical materials.

Semi manufactured goods: Goods in a semi-manufactured state or in the process of manufacture on the balance sheet date should be valued at cost, i.e., cost of raw materials, and a reasonable proportion of the factory or production overheads. To this end, the auditor should obtain a certificate from the production manager as to the portion of overheads attributable to the semi-manufactured goods.

Regardless of the method of absorption of overheads, whether a percentage of raw materials, labour or volume of production, the auditor should see that the method and its application will result in a fair allocation and that the same is properly reflective of the prevailing conditions.

Finished goods: Where finished goods have been purchased for resale, their valuation should be at the purchase price plus a reasonable proportion of the direct expenses incurred in connection therewith, such as freight, duty, etc.

In case finished goods have been manufactured, they should be valued at lower of the cost of manufacture and market price. Even where the client adopts a different method of valuation, it should be seen that these goods are never valued at a rate higher than the market price of identical goods in the market.

Goods on consignment: Goods sent on consignment should be verified by means of obtaining confirmation from the consignees. If the whole or part of such goods remain unsold on the balance sheet date, the auditor should, after satisfying himself that there is no deterioration in quality, ensure that these are valued at lower of the cost and market price. The cost in this case should also include a reasonable proportion of the expenses incurred on transshipment to the consignee, e.g., freight, duty, godown rent, etc. but expenses properly relatable to sales, such as commission, should not be included in the cost.

Where goods sent on consignment have been priced at the selling price, the auditor should see that a reverse entry in the accounts has been passed at the time of account-closing, such that the unsold stock is valued at cost alone.

Goods on approval or return: Where goods sent on approval have neither been approved nor returned until the balance sheet date, they should be deemed to be part of stock-in-trade and valued at cost plus other expenses attributable to them. These should be treated as sold only if the customer has neither communicated his approval nor returned the goods, though the date for it has expired.

Purchase commitments: Where the client has made any commitment to purchase materials at a price higher than the price on the balance sheet date, the auditor should see that a note to that effect is appended to the financial statements. The loss on this account should not be provided until the goods have been actually received, after which the principle of valuation at lower of cost and market price will apply.

Stores: These are in the form of lubricants, tallow, dyes, fuel etc. Their valuation should always be at cost irrespective of the current market price, though some accountants are of opinion that these should be valued at lower of the cost and market price.

3.6.3 Verification of obsolete and slow –moving goods: The auditor should be vigilant to note the existence of obsolete and slow-moving goods. He should compare stock accumulations with actual orders on hand and sales forecasts. If the accumulations seem to be excess of reasonable requirements, he should enquire whether these are due to faulty work in the production department, or because goods have become dated or out of fashion. If so, he should see that adequate provision for depreciation or loss is made and necessary adjustments are made in the books.

Plantation products: In a plantation business, stock of rubber, tea, coffee, etc. should be valued at an estimated selling price in the subsequent year less selling and distribution expenses likely to be incurred.

Work in progress: It means the total value of uncompleted production at the end of each financial period. It is represented by the materials on which varying amounts of labour

and overheads have been spent according to the specific stage in the manufacturing process, at which the material was found when the stock of work – in progress was taken.

While verifying work-in-progress, the auditor should first ensure that careful arrangements have been made to identify stock of "in progress" items, and for determination of the stage of completion or last completed operation. He should then carefully review the statements submitted by the management and tally the particulars with the control-sheet maintained by him for key materials giving details of opening stock, issues as recorded in the stores ledger, quantities included in the deliveries of finished goods, and the quantities scrapped. The number of articles under work in progress should also be verified, wherever possible, by an independent physical count, and any difference between it and the quantity mentioned in the managements statement should be investigated.

According to the Companies Act, work –in progress should be shown in the Balance Sheet as a separate item from stock-in trade.

Valuation of work in progress may be made either at cost plus a reasonable proportion of profit earned (or less any foreseeable, loss), or at lower of cost and net realizable value (or replacement cost). The auditor must ensure that figures as to expenditure on raw materials, wages and attributable overheads have been correctly compiled, and that the basis of valuation has been consistently followed and any material deviation from the past year's valuation carefully gone into. He should also see that the estimate of how far the work has progressed towards completion, have been correctly made. The completion percentage may be determined in a variety of ways, such as number of man-days spent, quantity of materials used, etc.

3.6.4 Auditor's duty as regards inventories

Correctness of the profits of a business is largely dependent on the care and skill with which inventories are verified. Even the slightest mistake on this count may cause profits to rise or fall in a big way, thus distorting the representation in the financial statements and making the auditor liable for negligence.

In carrying out his examination of the existence and valuation of inventories, the auditor is expected to use his own discretion regarding the extent of examination. In suitable circumstances, he may adopt a system of test checking. However, he is expected to make an intelligent scrutiny of the inventory – sheets and pay particular attention to the items which have a material bearing on the inventory and whose quantities or values appear to be unreasonable.

According to the Statement on Standard Auditing Practices" issued by the Institute of Chartered Accountants of India, the auditor is not a valuer but he is expected to examine the valuation of inventories in the following respects:

Within the limits of his knowledge and by means of a test check of the records and other information available to him, he must satisfy himself that the inventories have been correctly valued on the basis as stated.

He must ensure that the basis of valuation has been consistently adopted from year to year. Where the basis of valuation is changed, it would amount to a change in the basis of accounting and if the effect on profits is material, adequate disclosure should be made in the accounts or the notes. It may be noted that a similar situation may arise when the method suggested in the International Accounting Standard-2, is adopted for the first time.

He is required under section 227(2) of the Companies Act to report whether the Balance Sheet and the Profit and Loss Account of the company give a true and fair view of the state of the company's affairs and of its profit or loss. Part II of Schedule VI of the Act provides that the figures of opening and closing stock are to be given. Sec.227(3) (c) requires him to state in his report whether the company's Balance Sheet and Profit and Loss Account are in agreement with the books of account and return. Sec.227(1) gives him the power to have access at all times to the books and accounts and vouchers of the company, and to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor.

He is not expected to make a detailed examination of the cost records, but he should enquire into the general basis on which costs have been determined. Wherever feasible, particularly when only a single or a few major products are produced, he may call for reconciliation of the total cost of production for the year as determined by the cost records with the total expenses as per the financial books, and review the reconciliation. Where standard costs are used, or where overheads are charged at standard rates or percentages, he may examine the variances from actual and, where these are significant, ensure that appropriate adjustment is made to the inventions.

On a harmonious construction of these various provisions, it is clear that the auditor is required to satisfy himself not only about the quantity of the inventories but also about their valuation. This is in sharp contrast to the previous Company Law provisions under which the report by an auditor was a mere formality. In keeping with the exacting legal duty required of the present-day auditor, the Institute of Chartered Accountants of India has in its "Statement on Auditing Practices" made several suggestions as to verification of stock-in-trade, among other assets, and the ground covered by them is much wider than the laid down in the Kingston Cotton Mills case.

As held by the Supreme Court in Institute of Chartered Accountants V.P.K.Mukherjee (1968) 2 Comp. J.H.211, "The Audit is intended for the protection of the shareholders and the auditor is expected to examine the accounts maintained by the directors with a view to inform the shareholders of the true financial position of the company. "In Ministry of Finance v.S.N.Dasgupta, AIR (1943) Cal.414, where the auditor had qualified his report as "stock-in-trade at cost, as taken, valued and certified by the management". The Court held that the lapse was committed by the auditor's failure to perform a duty without which

an audit is meaningless, and it is not excused by giving information of the omission to the shareholders. An auditor who does nothing at all, does not even look into the accounts, cannot escape liability by stating in his report to the shareholders that he has done nothing, and assumes no responsibility whatever for any inaccuracy or untruth in the Balance Sheet or Profit or Loss Account. Of course, the auditor is not required to act as an appraiser or expert valuer. But he is required to apply tests, in conformity with generally accepted auditing standards, which are necessary in the circumstances of each case so as to afford a reasonable basis for his opinion on the inventories.

Important terms explained

Important terms used in the context of valuation of inventories are explained below:

Meaning of "cost": It is the amount, measured in money, which is expended in consideration of goods and services produced or purchased. Thus, it includes (a) the value of goods purchased for manufacture or resale; (b) direct expenses on manufacture or handling; and (c) overhead expenses.

In regard to items (a) and (b), there are different methods of ascertaining cost, as discussed below:

(a) Unit cost method: Under it, each article or batch of goods is valued at the actual price at which it is purchased. But it can only be applied where goods have been purchased in different lots, and it is also possible to identify the consignment of which such article or batch is a part, because then alone the cash memos or invoices concerning the relevant consignments can be referred to ascertain the cost of the goods forming part of the stock.

But where goods are purchased in bulk or in semi manufactured or manufactured state, it may be difficult to apply this method because of loss identify of goods so as to relate the item forming part of the stock to respective consignments. Further, under this method, overheads as allocated on the basis of estimation which may make it difficult to determine the correct cost figures.

(b) Simple average cost method: Where goods purchased under different consignments at different times are so mixed up that it is not possible to relate the items in hand to their respective consignments, for example, liquids such as oil stored in large tanks, valuation of stock is done as per simple average price at which individual consignments have been purchased.

(c) Weighted average cost method: It is an improvement over the simple average cost method, in the sense that under it due weight age is given to the quantities of goods purchased at different prices. Accordingly, the value of the stock is added to the value of purchases and the total amount is divided by the number of units in stock, plus those purchased. The stock in hand is valued at the rate so found.

(d) First in, first out (FIFO). Also called the original cost method, its basic assumption is that the goods received in successive lots are sold in the order in which they have been received, such that the goods in stock represent the latest purchases and the price at which these have been acquired is to be used for valuation of the stock.

(e) Last in first out (LIFO). It is just the opposite of FIFO, in the sense that it is based on the assumption that goods representing the latest purchase are the first to be sold out. Thus, the goods in stock are supposed to represent the earliest purchases and the rates of the same are used to value the stock in hand.

This method does not find much favour in the U.K. But in the U.S.A., it is not only popular but also accepted by the tax authorities, as held in Anaconda American Brass Ltd., v.Minister of National Revenue (1952).

(f) Base stock method. Under it, a specified quantity of stock is always carried at the original cost and it is not supposed to be issued unless there is an emergency. In fact, this quantity is treated as a fixed asset and it represents a part of the original lot purchased. It is valued at the same rate at which it was acquired, regardless of the subsequent fluctuations in price. As for the quantity in excess of the base stock, it may be valued according to any other method.

(g) Standard cost. This method is usually adopted by business concerns operating the standard costing system. Under it, the stock is valued at a price determined in advance after taking into consideration several factors, such as, the quantity of materials to be purchased, their present market price, future trends, and so on. Thus, the rate at which the stock is valued may neither be the cost nor the market price of the stock.

(h) Adjusted selling price method. Under this method, the stock is valued at the rate determined by deducting from the current selling price (a) predictable cost of completion and disposal; and (b) a normal profit margin.

In the case of manufactured or partly manufactured goods, the valuation is at "works cost" or market value, whichever is lower. Works cost means the cost of raw materials as calculated on the basis of any of the accepted methods discussed above, plus a reasonable amount of factory or production overheads which the client has consistently included in the valuation of stock. Generally, the includible factory overheads are (a) direct expenses such as wages, and (b) indirect expenses such depreciation of machinery, factory rent, materials handling, maintenance, supervision, insurance, etc. But works cost does not include general and administration expenses, and expenses which are incurred after the production stage, i.e., selling and distribution.

For absorption of overheads in the cost of stock, there are a number of accepted methods, viz., a percentage of raw materials or direct labour, or machine hour or labour hour rate. But the method and its application should be examined carefully to ascertain whether it makes a fair allocation of overheads and is in conformity with the current conditions. The

real test, as Lord Reid observed in the case of Duple Motor Bodies (1961), is “what method best fitted the circumstances of a particular business.”

Meaning of “market price”: Generally, market price means the price of a commodity as between willing buyers and sellers. The term “market price” may be relevant only in the case of materials for which price quotations can be obtained but in the context of valuation, it is also applied to goods-where price quotations are not obtainable.

It is common practice to use market value as meaning (a) current replacement cost, and (b) net realizable value.

(a) Current replacement cost. It means the cost which will be required to replace the inventory on the balance sheet date by materially identical items, whether by purchase or by production. The underlying principle is that the cost of replacing a piece is of greater importance to the business than the original cost of the piece, especially in a a period of generally rising prices. Valuation of inventory at current replacement cost is to be done where the same is lower than the original cost.

(b) Net realizable value: It represents the amount at which it is assumed that the items of inventory and work-in progress may be disposed of, without creating other profit or loss in the year of sale. i.e., the estimated proceeds of a sale, less (a) all further costs of completion; and (b) all costs to be incurred in marketing, selling and distribution directly related to the items in question.

Net realizable value may be less than the actual cost due to a variety of reasons, such as, (a) increase in costs or fall in selling price; (b) physical deterioration of stock ; (c) obsolescence; and (d) errors in production or purchasing. When goods are held in excess of the normal annual sales, the net realisable value of the excess stock may decline as compared to the actual cost, before the same has been sold away. In either case, the actual cost should be reduced to net realizable value according to some predetermined criteria, taking into account the age, past and future handling expenses, and scrap value of the goods.

Valuation methods:

Stock-in-trade is ordinarily valued at lower of cost and market price, and valuation as per this rule may be either in respect of each item in the stock or components, or in respect of all the items taken as a whole, depending on the character and composition of the stock. In the first case it is called the Individual (or Pick and Choose) Method, and the second, the Global Method.

(a) Individual or pick and choose method. Under it, the lower of the cost or market price, is taken in respect of each individual item of stock and the total of the same is the value of the inventory.

(b) Global method. Under it, first the cost of all the items is determined and aggregated. Then, the market price of all the items is ascertained and aggregated. The lower of the two valuations is the value of the stock.

Items of cost	cost	Market price	Lower of cost or Market price
1.	150	200	150
2.	300	250	250
3.	400	370	370
4.	500	625	500
5.	250	200	200
	1,600	1,645	1,470

In the present example, valuation of inventory as per the individual method will be Rs.1,470 and according to the global method it will be Rs.1600

Book debts

Book debts represent all money claims against debtors on open account. The object of verification in the case of book debts is to ascertain (a) the correctness of the amount; (b) their validity as claims against recorded debtors; (c) their collectibles and determination of the realisable value; and (d) appropriate disclosure in accordance with legal provisions and professional pronouncements.

According to the "Statement on Auditing Practices" issued by the ICAI, verification of debtors balances is carried out be employing the following procedure.

(a) year –end scrutiny and checking of balances:
(b) test checking of subsequent recoveries; and
(c) direct confirmation procedure.

Correctness of the amount of book debts: It can be verified by reference to the certified copy of the Schedule l of Debtors obtained from the client and the relevant accounts in the ledger. If in the course of evaluation of the internal control system, the auditor is also satisfied as to reliability of credit control system, balances as shown in the Schedule may be accepted as evidence of correctness of book debts.

Validity of book debts: Mere existence of a balance is the Schedule of Debtors is
no proof that it is owed to the client. This will require confirmation from the debtors concerned. But confirmations are not always available, and in any case, these will not disclose suppressed debtors balances arising from suppressed sales. According to the

Statement on Auditing Practices" issued by the ICAI, letters seeking confirmation from debtors should be sent either (a) as at the date of the balance sheet; or (b) as at any other date before the close of the year, after consultation with the client and after the books have been duly written up to the date selected for the purpose. If the number of debtors is large, letters seeking confirmation may be sent on a test basis. While such letters may prepared by the client, they should be posted by the auditor's own staff. The envelopes in which such letters are sent should bear the auditor's return address such that undelivered letters are only returned to him, and not to the client. A stamped envelope bearing the auditor's name and address should also be enclosed with the letter, such that confirmations are directly received by the auditor. These letters may be followed by reminders in case certain debtors do not respond. Replies to these letters should be carefully examined and in case of disagreement, the client should be asked to investigate the matter.

Collectibility: Confirmation of a debt is not an evidence of its collectibility. The auditor should make ageing analysis of the debts and classify them as those under 30 days, between 30 and 60 days between 60 and 90 days, and 90 days and above. This will enable him to ascertain the collectibility of individual debts.

Determination of non-collectibility of any debts will be based on the extent of credit-period allowed to the debtor concerned, regularity of payment by him and the number of times has defaulted in payments. Certain indications of doubtful or uncollectible debts may be as follows:

(a) continuous flouting of the terms of credit;

(b) old debts remaining unpaid while the new ones have been fully paid;

(c) payments are made on account though there is a constant rise in the balance in the account;

(d) stopping of payments after the withdrawal of credit facility;

(e) payment by acceptance of bills of exchange in the case of customers who only made cash payments before;

(f) dues from former employees;

(g) insolvency, disease, or death of the debtor;

(h) closure of business of the debtor or his disappearance;

(i) time-barred debts;

(j) discouraging correspondence with debtors; and

(k) old debts handed over to lawyers for filing suit.

In case any bad debt has been written off or any debtor has been allowed excessive discount, the auditor should carefully go through the relevant correspondence and see that there is proper authorization for the same.

Disclosure in financial statements: Book-debts are to be shown in the financial statements at their estimated realisable value, i.e., provision for doubtful accounts should be deducted from the total book-debts. According to Para I of Schedule VI to the Companies Act, the sundry debts of a company should disclosed in the Balance Sheet as follows:

(a) debts considered good and in respect of which the company is fully secured.

(b) Debts considered good for which the company holds no security other than the debtors personal security.

(c) Debts considered doubtful or bad.

(d) Less Provision.

Debts owed by employees, officers, directors, shareholders, or companies under the same management, fall in different category because of special debtor creditor relationship, and require a careful examination. The auditor should satisfy himself as to the reason for existence of such debts, and whether entries in the accounts have been made properly, and these have been incorporated in the financial statements. Debts from employees arising from transactions in the ordinary course of business need not be shown separately unless they constitute a sizable portion of the overall book-debts, or otherwise call for separate disclosure. But debts owed by directors, officers of the client-company, or by firms of private companies in which any director is a partner or director or member, or from companies under the same management (sec.370)are required to be shown separately, irrespective of how these have arisen, and whether or not they represent a significant amount.

3.6.5 Investments in ventures outside India

According to AS-11, “Accounting for the Effect of Changes in Foreign Exchange Rates,” investments made by Indian enterprises in ventures outside India should normally be classified as long term investments, as distinct from current investments which are held for not more than one year.

Long-term investments should be carried in the Balance Sheet at their original rupee cost. However, the carrying amount should be reduced to recognize a decline, other than temporary, in their value. Indicators of the value of such investments may be obtained by reference to their market values, prevailing exchange rate, the investees’ assets and results, and expected cash flows from the investments. The type and extent of the investor’s stake in the investees should also be taken into account. Restrictions on distribution by the investees or on disposal by the investor, may also affect the value of the investments.

Bills receivable

These denote a broad category of formal documents of indebtedness, including promissory notes and acceptances receivable. The object of verification in this case is the same as in book –debts, i.e., to establish the accuracy of amounts, validity of the bills as claims, collectibility, and a fair disclosure in the financial statements.

Accuracy of the amount of the bills is verified by reference to a certified Schedule of Bills Receivable in hand, and the related individual ledger accounts. Relevant transactions should also be examined to ascertain the genuineness of each bill.

Validity of the claim in respect of each bill can be verified by confirmation from makers or acceptors of bills, including those which have been discounted, endorsed, pledged, etc. Fro bills in the custody of persons other than the client, confirmation should be obtained not only forms the maker but also from the present holder, with a certificate whether these are held for collection, or as a security for a loan.

For establishing the collectibility of bills, the ageing schedule should be prepared. The auditor should also discuss with the client the collectibility of each bill and review the bills which are for material sums, or have matured or been renewed. In case bills have been collected subsequent to the balance sheet date, they should be verified by reference to entries in the Cash Book.

Where bills have been discounted, the auditor should determine the amount of contingent liability, i.e., the amount which the client might be required to pay if the maker or the acceptor fails to make payment upon maturity of the concerned bills.

But where bills have been endorsed without recourse, in which case the endorse assumes all credit risks, accounts thereof should be eliminated and no contingent liability need be shown.

Where the bills have been retired after the balance sheet date, the same should be verified by reference to Cash Book.

Payments in advance

These represent items, such as rent, rates, telephone or insurance, in respect of which payment has been made in advance, for services or rights to be received over some future period of time. The object of verification is, first, to ascertain whether these items have been fairly stated in the financial statements and, secondly, to use the information gathered in respect of certain items to support or contradict conclusions with regard to other phases of audit, such as, the amount rates and taxes will reveal ownership of property and that of the premium will point to adequacy or otherwise of insurance coverage.

Verification of these items should be by reference to the certified Schedule of Pre-Payments, respective ledger accounts and receipts and demand notes for the latest payments. Comparison with past year’s payments should be made and any significant variations thoroughly investigated.

As per the Companies Act, payments in advances have to be separately shown in the Balance Sheet.

Cash in hand

The object of verification of cash is to establish the accuracy and validity of cash balances as shown in the Cash Book. According to the “Statement on Auditing Practices” issued by the ICAI, the auditor should carry out cash verification at the year end or by way of a surprise check any time during the year.

Preferably, cash should be physically counted and tallied with the Cash Book balance. All funds in the same location should be produced simultaneously. If the cashier holds funds belonging to associate companies or staff clubs, their co-operation should be sought for simultaneous checking of funds.

Verification of shares, bills receivable, postal stamps and other such accounts should be done simultaneously with cash, because funds can easily be derived from accounts for substitution into cash balances. Verification of shares and bills should be made to ascertain that they are genuine and owned by the client. Particular care should be taken to examine the validity and propriety of vouchers for advances or expenses which may be included in the cash count on the pretext that these will be collected or reimbursed subsequently.

Another method of cash verification into asks the client to deposit the whole of cash balance on the balance sheet date with the bank. This will obviate the necessity of physically counting the cash in hand. But there is ample scope in this for the client or his staff to convert the shares or bills receivable into cash to make up any deficiency, and this possibility should be guarded against.

In case there is an unusually large cash balance at the end of the year, the auditor should ascertain whether the client really needs to hold so much cash in the ordinary course of his business. He should also enquire whether certain items have remained to be recorded in the Cash Book.

Cash at bank

The balance in the Bank Pass Book should be compared with that in the Cash book and any difference between the two should be reconciled by preparing Bank Reconciliation Statement.

Cheques deposited by the client, though not yet collected by the bank, should be verified from the records in the Cash Book and traced to credits by banks within an appropriate period thereafter. Similarly, cheques issued by the client but not yet presented for payment, should be traced to subsequent debits in the Pass Book.

Confirmation form the banks should be obtained separately in respect of Fixed Deposit Account, Current Account, and Savings Bank Account.

3.7 VERIFICATION OF LIABILITIES

The term liability is of a large and comprehensive significance and, in its usual and ordinary sense means a state of being under obligation in law. A liability always involves a future outlay of money or its equivalent. It owes its existence to an external transaction of the past and is the subject of calculation or estimation.

Liabilities may be classified as short –term (current) or long term.

Short term liabilities: Liabilities which are expected to be settled (a) by use of current assets; (b) by creation of other current Liabilities; and (c) within a relatively short period, usually one year, are current liabilities. Thus, trading liabilities arising from acquisition of materials and supplies, deposits from customers, accruals for obligatons arising form business operations (e.g. salaries, wages, royalties, rentals, taxes, and other operating expenses), bills payable, approximate accruals such as bonus payments, etc., are current liabilities.

Long-term liabilities: Liabilities which do not answer the description of short-term liabilities are long-term liabilities. Important examples of long-term liabilities are: debentures and bonds, mortgages, loans and advances, long-term obligations under pension plans, reserves etc.

Contingent liabilities: A liability y which, by reason of something done by the person bound, will necessarily arise or come into being if one or more uncertain events occur or do not occur, is a contingent liability, e.g., in respect of bills receivable discounted which have not matured, calls on partly paid shares, guarantees etc.,

Audit objectives

Verification of liabilities is aimed at ascertaining that they are within authority of the client and properly valued, classified and disclosed in the Balance Sheet.

Proper disclosure does not merely mean disclosure of liabilities as recorded in the books on the balance sheet date, but it coervs even those liabilities which, for one reason or another, have not been recorded in the books, thus, while the auditor may obtain a certificate from a responsible official of the clients to the effect that all business liabilities have been recorded in the books, he will be guilty of negligence if he does not apply reasonable care and skills to determine its veracity.

As regards auditor's duty as to disclosure of unrecorded liabilities, it has been held in Westminster Road, Construction and Engineering Co. Ltd. (1932) that if it is found that a company in the course of its business is incurring liabilities of a particular kind, and the creditors send in their invoices after an interval, it is the auditors duty to make specific inquiries as to the existence of such liabilities.

Trade creditors

The auditor should obtain a certified Schedule of Creditors from the client and check it with the individual creditors accounts in the Purchase Ledger. Particular care should be taken to see that al purchases, including those made at the year – end, have been included and duly credited to the accounts or the creditors concerned. These should, if necessary, be further checked with all original records as to purchases, i.e., Purchase Book, Goods Inwards Book, Purchases Returns Book, Bills Payable Book, invoices, credit notes, and respective ledger accounts.

As held in Westminster Road Construction and Engineering Co. Ltd (1932) the auditor has a duty to determine unrecorded liability in respect of goods received prior to the end of the period under audit which, though included in stock, do not have corresponding entry under liabilities. He should also send confirmation requests to a select number of creditors concerning the balances standing as at the end of the year. This should particularly be done in the case of suppliers with whom the client has begun to have dealings in the year under audit, because it may be that not existent goods are shown as having been purchased and the proceeds are shared between suppliers and dishonest employees.

Gross profit ratio of the current year should also be compared with that of the previous year and material variation carefully probed.

Deposits form customers and employees.

The auditor should obtain a certified copy of such deposits with proper classification as to deposits received from customers as security for payment of bills, and those from employees as security against misappropriation, etc. The deposits should be confirmed directly with the individuals concerned.

If should be said that the amount is deposited in a separate bank account, confirmation in respect of which should be duly obtained form the bank. The amount should also separately be shown on the liabilities side of the Balance Sheet.

Outstanding expenses

Most common accruals is respect of obligations arising from business operations relate to salaries, wages commission, and other remuneration earned by employees, but payable to them in the accounting period after the end of the current year.

The auditor should obtain a certificate from the management that accrued liability in respect of all such expenses has been recorded in the books of account. As for salaries and wages, he should examine the Salaries Register and Wages Sheets for the period under audit. As regards commission, he should ascertain the method of its computation by reference to the agreement with salesmen and agents. In regard to bonus payment, he should study the minutes of the meetings of the Board of directors to ascertain the basis of

computation of such payment, and also make his own calculations to test veracity of the liability remuneration to managerial personnel should be verified as to authority from minutes of the Board and shareholders meetings and compliance with Sec. 198 and 309 and Schedule XIII to the Companies Act.

Bills payable

The auditor should obtain a list of outstanding obligations on account of bills payable as to purchase of goods and services for the purposes of client's business. This should be checked with the Bills Payable Book and Bills Payable Account and any variation between the two should be properly reconciled.

Payments on account of the bills after the balance sheet date should be traced to the corresponding entries in the Cash Book.

Tax liability

Determination of client's liability as to various taxes and its proper disclosure in the balance Sheet is an important duty of the auditor. This requires him to be familiar with the tax laws and their effect on the business transactions of the client.

As for liability to income tax, there may be variation in the accounted income and the taxable income, owing to different treatment of certain incomes or expenses in the books of account. This should be reconciled in the light of legal provision and apast years assessments.

In the case of State taxes, there are often different provisions in different States and the auditor is required to be particularly knowledgeable about them so as to ascertain whether, and to what extent, the client will have liability in the case of a particular State tax. He should seek expert legal opinion in the case of any doubt or difficulty.

According to the "Statement on Auditing Practices" issued by the ICAI, if a tax liability has been appealed against and the grounds or appeal are apparently bonafide and valid, a provision for such liability need not be made and only a disclosure by way of a note to the account will be enough compliance with the audit requirements. However, the decision as to whether the grounds of appeal are bonafide and valid, will have to be backed by relevant case law or retrospective amendment to the law supporting the company's contention. If the grounds of appeal are not so, a provision for tax liability ought to be made and the audit report should be appropriately qualified.

Loans and advances

In the case of secured and unsecured loans, the auditor should first ascertain whether they are within the borrowing powers of the client. Next, he should examine documents, such as loan agreement and correspondence with lenders, in the order to ascertain the conditions regarding interest rate, and mode and time of payment of interest and the

principal. He should also examine if the loan has been taken wholly and exclusively for the business. In the case of loans involving large sums, the outstanding balance and interest may also be confirmed by the lenders.

As regards secured loans, the actual amount thereof and the nature of security provided, e.g., pledging of investments such as shares and stock, mortgage on property, hypothecation or guarantee, etc., should be examined.

In the case of a company audit, the auditor should ascertain that in the case of loans taken from companies, firms or other parties which are listed in the registers maintained under Sec.301 and 370 (1-C) of the Companies Act, the rate of interest and terms and conditions of such loans are prima facie not prejudicial to the interests of the company. Under Sec.301, a register in required to be maintained to record contracts with individuals, firms and bodies corporate in which a director of the company is interested. Under Sec.370 (1-C), record is required to be kept in a register as to all loans made to bodies corporate under the same management.

The rate of interest and other terms and conditions are prima facie prejudicial if they adversely affect the interests of the company as represented by its profitability, growth, steadiness, etc.

Debentures

The auditor should examine the Memorandum and Articles of the Company to ascertain its borrowing powers, and see that these are not exceeded. He should verify the Debentures Trust Deed and Debentures Account in the ledger, and Check the relevant entries in the books of account, in case debentures have been issued at a premium or discount. Confirmation requests may also be sent to individual debenture-holders to ascertain the correctness of the balance in Debentures Account.

The auditor should ascertain that the client has made adequate arrangements for redemption of debentures. Generally, a Debenture Redemption Reserve is created for this purpose and the same should be verified together with authorization about the same in the Articles of Association and the guidelines issued by the Securities and Exchange Board of India (for details, see Chapter 21, “Companies Audit-Audit of other Items”)

Reserves and funds

The auditor should examine the minutes of the meetings of the Board and see whether the decision to create a reserve or fund is dictated by needs and circumstances of the business and relevant legal provisions. He should also check the entries passed of the purpose in the Profit and Loss Appropriation Account.

Income received in advance

If it is customary for the client to collect incomes such as interest, rent, subscriptions, installments, etc., in advance, unearned portion of such income, not applicable to the period under review and deferrable to the next accounting cycle, should be classified as a liability and shown as such in the Balance Sheet.

The auditor should obtain a Schedule of Incomes Received in Advance and ensure that these are fully disclosed in the Balance Sheet. In the case of installment sales, deferred profit is usually computed by reference to gross profit percentage on total installment sales for an accounting period. As the percentage is likely to vary from year to year, the auditor should apply a proper percentage to the installment collections.

Provident fund dues

The auditor should ascertain the prescribed time limit within which deposit of provident fund dues with eh appropriate authority has to be made, and see if the client conforms to this requirement. In the case of irregularity in making the deposit, he should ascertain the extent of arrears of provident fund dues. Provident fund dues include employee's sown subscriptions, employer's contribution recovery of loan, and interest as prescribed under the Provident Fund Act.

According to Sec. 418 of the Companies Act, a company is required to make the payment of the provident fund dues by the due date, i.e., within 15 days from the date deduction form salaries of employees. The auditor has to state in his report whether the company is regular in depositing the dues and if not, the extent of arrears on the Balance Sheet dates.

Retirement gratuity

According to the Statement of Treatment of Retirement Gratuity in Accounts issued by the ICAI, the need to provide for accruing gratuity liability is based on sound accounting considerations, irrespective of whether or not it is allowed as a deduction while computing the taxable income. Accounting of the financial obligations for payment of retirement gratuity can be done in any of the following ways; First, payments actually made on account of gratuity may be debited to the revenue account in the year in which gratuity becomes due and payable. Secondly, a provision may be made in the books of the company for the accruing liability for gratuity by debit to the revenue account in each year and the aggregate amount of provision may be shown in the balance sheet. Thirdly, a separate gratuity fund may be administered by trustees, and contributions may be paid to the trustees each year and charged to the revenue account.

Computation of the accruing gratuity liability under the second and the third methods may present some difficulty, as it will involve an estimate of yearly accrual of liability based on the time of actual payment and the salary of an employee with reference to which it is to be calculated. Since in either case there may be over –or – under provision for the liability, it is recommended that the provision or non provision should be based, as far as

possible, on a computation determined by the use of actuarial principles. However, if for any reason an actuarial computation has not been obtained and a provision has been made, or the disclosure of over under or non provision is based on any other method of computation, the accounts should disclose this fact and indicate broadly the basis of calculation.

Actuarial valuation may not be necessary or practicable in all cases, for example, in the case of a small business, or if the number of employees is small. In such a case, provision for gratuity as also its disclosure, may be calculated on an ad hoc basis, on the assumption that all employees will be entitled to gratuity at the end fo the accounting year, rather than by way of an actuarial computation. However, in such a case, the accounts should disclose that the provision or the disclosure is based on a method of calculation other than an actuarial computation.

Creation of separate gratuity fund is a matter within the discretion of the management and dependent on factors, such as, availability of finance, tax liability as to interest on investment of the fund, etc.

Contingent liabilities

According to the Statement on Auditing Practices issued by the ICAI, contingent liabilities refer to possible liabilities arising from past circumstances or actions which may or may not crystallize into actual liabilities and which, if they do become actual liabilities, give rise to a loss, or an expense, or an asset of doubtful value. The factor of uncertainty as to whether or not there will be any legal obligation differentiates a contingent liability from an actual liability.

Some examples of a contingent liability may be (a) law suit against company in respect of patent or trade mark infringements, pollution of the environment, or sale of defective or harmful products; (b) as a member of a company limited by guarantee or (c) as partner of a firm; or (b) as surety or guarantor.

Inspection of the minute books of meetings of the Board of directors, contracts, bills sent by the lawyers, and inquiry and discussions with the staff of the company will provide vital information as to contingent liability that may have to be borne by the company.

Unless a contingent liability is quite negligible, its existence should be disclosed by an appropriate note in the Balance Sheet. According to part I – A of Schedule VI to the Companies Act, disclosure of a contingent liability need only be made through a footnote in the Balance Sheet specifying the amount involved. A provision for such liability may also be created in the accounts if the directors so decide. In such a case, the auditor should examine the Board’s resolution creating the provision and ascertain the facts and circumstances relevant to it. He should inspect the various contracts entered into by the company and assess, after discussion with responsible officials, the likelihood of any contingent liability arising there from. He should also obtain a certificate from the

management to the effect that all contingent liabilities, which are apprehended to materialize at a future date, have been duly disclosed and provided for as per the criteria determined by the board.

Capital

Owner's capital is not, strictly speaking, a liability of the business but as the auditor is required to express his opinion as to the truth and fairness of representations made in the Balance sheet; it is in the fitness of things that business capital be duly verified by him. His responsibility on this account is as follows.

Sole proprietorship: In the case of a new audit, the auditor should make an analysis of the owner's Capital Account, preferably from the date of inception of the business. In the case of repeat audit, he should analyse and substantiate the changes in Capital Account between audit dates. He should also ascertain the true nature of personal drawings, i.e., whether these are for business or private purposes.

Any change in the capital balances between the audit dates should be carefully examined. The owner may also be asked to confirm the final net worth amount as shown in the audited Balance Sheet.

Partnership: Verification of Capital Accounts of partners should be along the same lines as in the case of sole proprietorship, except that here the auditor is required to be more vigilant because of larger and more complicated details.

The auditor should carefully go through the Partnership Deed to ascertain – (a) capital contribution by each partner, (b) provision for partners drawings, salaries, commission, etc., (c) profit and loss distribution ratio; (d) method of accounting particularly in the case of distribution of profits, payment of salaries, commission, interest, loans, etc., and (e) treatment of excess capital contribution or capital deficiency.

It should be seen that sums credited to the partners on account of profits, salaries, commission interest, etc., are as per the Partnership deed Similarly, sums char4ged to partners on account of interest on drawings, loans, capital deficiency, etc., should also satisfy this test. In the case of drawings, each item should be carefully vouched. Where frequent small withdrawals in cash are noticed, for which written proof may not be available, these should be confirmed with the partners concerned to safeguard against possible misappropriation by employees. Where any partner has withdrawn trading goods for personal use, the value of goods as determined accordance with agreement between the partners, should be debited to his account. The method of such valuation should be consistently followed.

Particular care is called for to detect any mix up of partners private affairs with those of the firm. These should be properly disclosed and correcting entries for the same be checked.

Changes in the balances in capital accounts should be carefully verified and disclosed in the Balance Sheet, or in Statement annexed thereto.

3.8 AUDIT OF DEPRECIATION

Why depreciation is to be provided?

The amount depreciation charged against profits of an accounting period should be adequate. Non-provision or under statement of depreciation will lead to inflated profits, and any distribution of dividend based on such profits will be legally incorrect as it would result in return of capital to the shareholders and decrease in the value of business.

Failure to provide depreciation on an asset would create an anomalous situation at the end of the useful life of the asset when it would become a mere scrap. This is because the loss of cost (less scrap) will then be debited to the Profit and Loss Account of a single year though, in fact, the loss should be properly allocated over the years during which the asset has been used.

Non-provision of depreciation will mean that the asset would be shown in the Balance Sheet at cost, though in effect it is subject to diminution value with each passing year. This will distort the picture of the state of affairs of the business.

Provision of adequate depreciation on an asset should ensure its smooth replacement, in the sense that necessary funds would be available for the purpose at the time of replacement. It may be argued that if the amount of depreciation charged to profits year after year is not set apart for the purpose of replacement of the asset concerned but spent on general assets or for some other purpose, there may not be any funds specifically earmarked for replacement of the asset in question. However, even in such a case, the amount will have been retained in business, only, in the form of some asset or the other.

Under Sec. 205 of the Companies Act, it is compulsory for a company to provide depreciation before dividend is declared out of the profits of any financial year. This provides legal recognition to the principle that depreciation is an essential charge against profits in the same way as wages, cost of materials, overheads etc.,

3.8.1 Objectives of depreciation audit

The following are the principal objectives of depreciation audit:

- To see that the accumulated cost of the asset, i.e., initial cost plus additions and extensions of a capital nature, has been correctly computed.
- To see that the accumulated cost has been allocated as equitably as possible to the periods during which the asset is expected to be useful.

- To see that the value of the asset (less depreciation), as shown in the Balance Sheet, reasonably represents the remaining useful life of the asset.
- To see the there is adequate provision for current year's depreciation and that it has been computed in accordance with the generally accepted accounting principles applied on a consistent basis. This means that the cost of the asset should be depreciated by an acceptable method consistently applied over the estimated useful life of the asset.
- To see that there is adequate disclosure of the method of depreciation employed and of any change made therein.

3.9 DETERMINATION OF DEPRECIATION

Determination of depreciation and the quantum of the amount to be charged on that account in any accounting period will be usually based on the following factors;

- Historical cost of the asset or any other amount substituted in its place upon revaluation of the asset.
- Estimated useful life of the asset.
- Estimated scrap/residual value of the asset.

Historical / Revalued cost

Historical cost of an asset represents – (a) the money outlay or its equivalent in connection with its acquisition, installation or commissioning; and (b) the cost of additions and improvements thereto, if these are of a capital nature. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuation, price adjustments, changes in duties, or similar factors.

Evaluation of 'historical cost" Historical cost is based on actual costs incurred. Accordingly there is little element of subjectively in determination of the cost. However, when costs and prices rise at significantly higher rates, historical cost may not be the correct basis of determining the amount of depreciation as it will not reflect the true and fair picture of the state of affairs of the enterprise for the following reasons: (a) the value of the fixed assets as shown in the balance sheet at cost will not represent the current value; (b) the depreciation charged on the basis of historical cost will not be related to real value of the assets consumed during the accounting period in terms of their current value to the enterprise and this will overstate the profits in real terms.

Sandilands Committee. Sometimes, historical cost of an asset may be substituted by its current value to the business for the purpose of determination of depreciation. The Sandilands (Inflation Accounting) Committee of U.K. has also recommended the

revaluation method to determine the profits of the business after charging the current cost of stocks and fixed assets consumed, instead of original cost of the stock and depreciation based on the historical cost. However, the Committee observed that the value to be placed on any asset(s) should be its value to the enterprise, which means only the relative, rather than general, changes in costs and prices should be taken into account.

In case there is any addition or extension to an existing asset involving expenditure of a capital nature, it also will be deemed to be part of the historical / revalued cost of the asset for the purpose of determination of depreciation thereon.

Useful life of assets

Determination of useful life of an asset is a matter of estimation and it will depend on a variety of factors. According to AS-6, “Depreciation Accounting” issued by the ICAI, “useful life” of an asset is – (a) the period over which a depreciable asset is expected to be used by the enterprise; or (b) the number of production (or similar) units expected to be obtained from the use of the asset by the enterprise.

Useful life on an asset is shorter than its physical life. It is dependent on factors such as –

(a) legal or contractual obligations, such as physical life. It is dependent on patents, leases etc.,

(b) extent of extraction or consumption;

(c) extent of use and deterioration on account of wear and tear which, on its part, will again depend on the operational factors, eg., number of hours for which the asset has been worked during the accounting period and repair and maintenance policy of the enterprise;

(d) obsolescence caused by factors such as (a) technological changes; (b) improvement in production methods; (c) change in market demand for the product or service output of the asset; and (b) legal or other restrictions.

However, determination of the useful life of any asset for the purpose of depreciation, should not be a one-time exercise. There should be periodical review of the useful life of all major assets of the business and, if necessary, rates of depreciation should be adjusted in case there is significant variation in the estimate of useful life of any asset. In every such case, the effect of change should be adequately disclosed in the financial statements of the accounting period of question.

Scrap / residual value

It is not easy to determine the scrap/residual value of an asset and its estimate is bound to be affected by a number of technological and market factors during the useful life of the asset. Thus, whether the scrap value of an asset is estimated to be mere “nil” figure, or a significant sum, in either case the estimate will be a mere guess –work.

However, since estimate of scrap value is essential to determination of the rae of depreciation, whether at the time of installation or revaluation, it should be done carefully taking into account all the likely factors that might affect it.

3.9.1 Methods of Depreciation

There are a variety of methods as per which depreciation may be provided in respect of depreciable assets of an enterprise. According to AS-6, "Depreciation Accounting" issued by the ICAI, the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. It does not prescribe any particular method to arrive at the amount of depreciation, but it emphasizes that the method once selected should be applied consistently from period to period. In the case of change in the method of depreciation, either to comply with any legal provision or accounting standard, or to make the preparation and presentation of financial statements more appropriate, the unamortized depreciable amount should be charged to revenue over the remaining useful life of the asset. The effect of such change should also be quantified and disclosed fully.

The following are amount the more important methods of depreciation:
Straight –line or fixed installment system Under it, the annual provision in computed by dividing the cost of the asset (less scrap value, if any) by the number of years of its expected useful life. Thus, an equal amount is written off each year during the expected useful life of the asset, such that the cost is reduced to nil at the end.

For example, if the cost of an asset is Rs.2,00,000 its expected useful life is computed at 10 years, and the scrap value, at Rs.50,000, the amount of depreciation would be Rs.15,000 each year, worked out as follows:

$$\frac{\text{Cost less Scrap value (Rs.2,00,000 – Rs.50,000)}}{\text{Expected useful life (10 years)}}$$

Straight line method of providing depreciation is simple and safe, particularly in the case of assets where expected useful life is easily found, e.g., leases, patents, copyrights, and plant and machinery.

Reducing balance method

It is also known as Written – Down Value Method of Diminishing Balance Method. Under it, a fixed percentage of a diminishing value of the asset is charged to the profits every year. Unlike Straight line Method, in which depreciation percentage is applied to the original cost, in the present method such percentage is applied to the balance that remains after charging depreciation at the end of the previous year.

For example, if depreciation in respect of an asset costing Rs.20,000 is to be provided @ 10%, assuming the scrap value to be nil, then depreciation for each year would be worked out as follows:

- First Year : Rs.2,000 (@ 10% on Rs.20,000)
- Second Year : Rs.1,800 (@ 10% on Rs.20,000 – Rs.2,000)
- Third Year : Rs.1,620 (@ 10% on Rs.18,000 – Rs.1,800)
- Fourth Year : Rs.1,458 (@ 10% on Rs.16,200 – Rs.1,620)

The incidence of depreciation under this method is heavier on profits in the earlier years of acquisition of the asset, and thereafter it declines progressively from year to year, though the value of the asset is never completely written off. This has the effect of equalizing the depreciation charge to profits, together will repairs over the years. In this respect, this method is better than the Straight Line Method under which the incidence of depreciation and repairs falls more heavily in the later years.

Annuity method

Under this method, the value of the asset together with interest on the capital outlay thereon, is written off by way of depreciation. This is based on the assumption that if the outlay on the asset had been invested elsewhere, it would earn interest which ought, therefore, to be regarded as pert of the cost of the asset to be written of along with usual depreciation charge.

The amount of depreciation to be charged annually is determined from the Annuity Tables, taking into account the rate of interest to be charged on the capital outlay, and expected life of the asset. But while the amount of annual charge is constant, in the initial years only a small sum of the capital outlay is written off because a large part of the charge is towards writing off the interest. With the passage of years however, the sum available for writing off the capital sum grown larger.

This method is especially suited to assets with a long life and requiring huge capital outlay, such as long term leases. But due to complexity of calculations, it is difficult to apply it is cases where additions to assets like plant and machinery is made during the course of a year. Further, at least in the initial years, the asset is shown in the Balance Sheet at a valuation that is higher than its actual worth.

Sinking or Depreciation or Amortization Fund method

It is suitable in cases where a large amount of capital outlay would be necessary to replace an asset at the end of its expected working life. Under it, the amount of annual depreciation on the asset is credited to a Sinking Fund Account, and such amount is invested in Government or other approved securities and debited to the Sinking Fund Investment Account. Interest earned on the investment is credited to the Sinking Fund Account but further invested in similar securities, with a debit entry in the Sinking Fund investment Account.

The amount of annual depreciation to be invested in securities is calculated on the basis of Sinking Fund Tables such that, together with amount of the interest earned, it is enough to replace the existing asset with a new asset. Thus, when the asset's working life is over, the securities are sold and the new asset is acquired with the proceeds of sale of securities. In the books of account, the book value of the old asset is transferred to the Sinking Fund Account. The proceeds of scrap value, as well as any profit or loss on the sale of securities, is also posted to the sinking Fund Account, and the balance in the account is transferred to the Profit and Loss Account.

In case the cost of replacement of an exceeds the original cost of the existing asset, and it is not proposed to raise any fresh capital for the purpose of its replacement, the amount of investment will naturally be more than the amount of annual depreciation. The excess sum in such a case will represent appropriation of profits which is credidted to a plant Rehabilitation Reserve, rather than the Sinking Fund Account.

Insurance policy system

Under this method, an endowment policy is taken on the life of the asset and at the end of its working life; the amount necessary for its replacement is realized from the insurance company.

The amount of annual depreciation, instead of being invested in the purchase of Government or other approved securities as in the case of Sinking Fund Method, is used to pay the annual premium on the endowment policy. The amount of premium is debited to the Policy Account.

Depletion unit method

It is particularly useful in the case of wasting assets like mines, oil wells, and quarries. Under it, the cost of resource (mine, quarry, etc.) is divided by the estimated production to get a per –unit "depletion facto". The annual amount of depreciation is then calculated by multiplying the quantity extracted during the year with the per unit "depletion factor".

The estimated production may represent assured reserves of the minerals or only estimated recoveries. In the case of the latter, estimation will naturally be more hazardous and tentative. In the normal course, the auditor should be reluctant to accept this basis unless he has it on the authority of recognized geological experts that the realization of the expectation is highly probable. To base the per unit depletion rate on assured reserves is more acceptable of the two, because under it there is an approximation of the diminishing Balance Method and the incidence of depreciation falls more heavily on the earlier years.

Machine –hour rate

It is a variation of the Straight Line Method, the difference being that in this case depreciation is calculated on the basis of the number of hours a machine has been worked. Under this method, the total number of working hours of the machine during its expected

useful life is estimated, and the original cost of the machine(less scrap value, if any), is divided by the number of the working hours. The resultant sum will indicate the hourly rate of depreciation of the machine.

This method can be usefully applied in the case of expensive machines having a limited life which, moreover, is easily measured in terms of working hours, But it is quite time consuming and therefore expensive, in the sense that hourly record of the working of each machine has to be carefully maintained. Moreover, the hourly rate may have to be changed in the light of technological or economic conditions.

Revaluation method

Usually, this method is applied in the case of rapidly depreciating assets, such as, loose tools, livestock, patents, etc. Under it, the asset is revalued at the end of each accounting period and the difference between the value at the beginning of the period, and the value at the end thereof is treated as depreciation. However, appreciation in value at the end of the year is not taken into account.

Production unit method

Under it, annual depreciation is calculated by dividing the cost of asset (less scrap value) by an estimated number of units to be produced during the life of the asset. However, this method can be applied only in the case of plant and machinery producing identical or uniform goods. Moreover, since depreciation is related to the actual use of the machine during the year, no depreciation is charged if the machine remains idle. Also it entails maintenance of detailed records as to output.

3.9.2 Rates of Depreciation

The rates of depreciation may be single or composite. Where a rate is calculated by reference to the estimated life of a single asset, it is a single rate. On the other hand, where it is calculated by dividing the aggregate of the individual depreciation charges in any one period of all the assets concerned, by the aggregate of the costs (less scrap value) of those assets, it is called a composite rate.

However, grouping together of different assets for the purpose of calculation of a composite rate may not be advisable, particularly where the assets are used for different jobs, products or services.

3.10 DEPRECIATION UNDER THE COMPANIES ACT

Sec.205 of the Companies Act has made it mandatory for a company to provided depreciation before any dividend is declared or paid by it to its shareholders, out of the profits of any financial year. Sec.205 (2A) provides that before declaring or paying dividend for any financial year, the company has not only to provide depreciation in accordance with Sec.205(2) but also to transfer to its reserves up to 10% of its profits for

that year, though the company may at its option transfer a higher percentage of its profits to the reserves in accordance with the Companies (Transfer of Profits to Reserves) Rules, 1975.

Sec.205 (2) lay down the following methods for providing depreciation:

- Depreciation may be provided to the extend specified in Sec.350, i.e., othe amount calculated with reference to the written down value of the assets as shown by the books of account of the company, at the rate specified in Schedule XIV to the Companies Act.
- Depreciation may be provided in respect of each item of depreciable asset, for such amount as is arrived at by dividing 95% of the original cost thereof to the company, by the specified period in respect of such asset.
- Depreciation may be provided on any other basis approved by the Central Government which has the effect of writing off, by way of depreciation, 95% of the Original cost to the company of each such depreciable asset on the expiry of the specified period.
- Depreciation may be provided as regards any other depreciable asset (for which no rate of depreciation has been laid down in Schedule XIV to the Companies Act or the Rules made there under) on such basis as may be approved by the Central Government by any General order published in the Official Gazette or by any special order in any particular case.

It will be seen that out of the four methods laid down by Sec.205(2), only the first method relates the calculation of depreciation to the written –down value (i.e., reducing balance method), while the second and the third methods refer to the straight line method of depreciation and are concerned with writing off 95% of the original cost of the asset to the company. The fourth method is to be adopted only where Scheduled XIV or the Rules give no rate of depreciation in respect of any asset and the basis of providing depreciation is approved by the Central Government by a general or special order.

SCHEDULE XIV – RATES OF DEPRECIATION

The Schedule given separate rates in case of reducing balance method and straight –line method. Also, in the case of certain assets which are worked for more than one shift, higher rates have been provided for double and triple shift working.

Some important assets and rates of depreciation as given in Schedule XIV and revised by the Department of Company Affairs vide file No.1/12/92 CL. V dated 16th December 1993, are as follows:

Nature of assets	Single shift *WDV	**SLM	Double shift WDV	SLM	Tribe shift WDV	SLM
• Building (other than Factory buildings) **** NESD)	5%	1.63%				
• Plant and machinery, Other than Continuous Process Plant, for which no special rate is prescribed						
General rate	13.91%	4.75%	20.87%	7.42%	27.82%	10.34%
Continuous Process plant for which no special rate is prescribed:	15.33%	5.28%				
• Furniture and fittings ;						
General rate : ***NESD	18.1%	6.33%				
Special rate in other cases : ***NESD	25.88%	9.5%				
• Ships :						
Ocean-going ships						
(a) fishing vessels with wooden hull ***NESD	27.05%	10%				
(b) Dredgers, tugs, etc.	19.8%	7%				
Ships operating on inland waters-						
(a) Speed boats *** NESD	20%	7.07%				
(b) Other Vessels ***NESD	10%	3.34%				

* WDV means written down value
** SLM means straight –line method
*** NESD means no extra shift depreciation.

- **Reducing balance method.** The reducing balance method of providing depreciation is permitted to be used both under Secs.205 and 350. Under it, the rate of depreciation in respect of any asset would be the rate as prescribed in the case of that asset in Schedule XIV to the Companies Act or Rules made there under.

The calculation of extra shift depreciation, where applicable, for double shft and triple shift working, shall be made separately in the proportion which the number of days for which the concern has worked double shift or triple shift, as the case may be, bears to the

normal number of working days during the year. The normal number of working days during the year shall be deemed to be ---

- in the case of seasonal factory or concern, the number of days on which the factory or concern has actually worked during the year, or 180 days whichever is greater.
- in any other case, the number of days on which the factory or concern has actually worked during the year, or 240 days, whichever is greater.
- **Straight –line method.** Under this method, which is permitted to be adopted under Sec. 205, the rate of depreciation is to be calculated by dividing 95% of the original cost of the asset to the company by the specified period concerning the asset.

Specified period in respect of any depreciable asset, as defined in sec.205 (5), means the number of years at the end of which at least 95% of the original cost of the asset will have been provided by way of the rates as prescribed under Schedule XIV.

For example, if the depreciation rate for an asset under Schedule XIV is 10% and if 95% of the cost of the asset is to be written off under the Reducing Balance Method, in about 28 Years, then the straight line rate for the asset will be 95/28= 3.39%

- **Any other method**. Even where any method other than Reducing Balance Method or Straight Line Method is adopted for the purpose of providing depreciation, with the approval of the Central Government under Sec.205(2)(c), it should provide for writing off at least 95% of the original cost of the asset to the company on the expiry of the specified period.

- **Where no rate is given under Schedule XIV or Rules.** Where in respect of any asset. Schedule XIV has not prescribed any rate of depreciation, it would not be possible to provide depreciation under any method because in each case the specified period is required to be calculated with reference to the rates of depreciation under the said Schedule. In such a case, depreciation may be provided on a basis approved by the Central Government by any general order published in the Official Gazette, or by any special order made in a particular case.

In the case of wasting assets like mines and quarries, for example, the Schedule does not prescribe any rate of depreciation. However, as stated by the Company Law Department, depreciation is to be provided in the case of all assets, whether or not a rate for the same has been prescribed.

Depreciation at a higher rate

According to a note on “Provision of Depreciation”, issued by the Research Committee of the Institute of Chartered Accountants of India, depreciation calculated in accordance with Secs.205 and 350 of the Companies Act, should be only regarded as the minimum amount of depreciation. If a company is of opinion that depreciation at a higher rate than that prescribed under the above Section is necessary to enable it to write off an asset over its

normal working life, it can provide deprecation at a higher rate. However, only the Board of directors of the company can make a decision as to adequacy of the rate of depreciation and, ordinarily, the auditor should rely on the Board's decision unless he finds the decision to be grossly unreasonable.

Change of depreciation method

The main objective of depreciation audit is to ascertain that the total cost of asset is depreciated by an acceptable method, consistently applied over the estimated life of the asset. Under the law, a company is only required to ensure that there is a true and fair provision for depreciation of all its depreciable assets. There is thus no compulsion as to which method should be provided. As we have already seen, along with the Straight-Line and Reducing Balance Method prescribed by law, there is also mention of "any other method" which may be followed by the company with the Central Government's approval.

According to AS-6, "Depreciation Accounting" issued by the ICAI, a change from one method of providing depreciation to another should be made only if adoption of the new method is required by Statute, or for compliance with an accounting standard, or if it is felt that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When a change in the method of depreciation is made, the unamortized depreciable amount of the asset should be charged to revenue over the remaining useful life of the asset by applying the new method. Such a change should be treated as a change in accounting policy and its effected should be quantified and disclosed.

The question-whether the change in the method or rate of depreciation should have retrospective effect-should be resolved on the basis of materiality and circumstances of each case. According to some experts, past year's calculations made in good faith and after taking into account the circumstances then prevailing, should not be disturbed in the light of subsequent developments. However, opponents of this viewpoint hold, and perhaps validly so, that any such change should be made with retrospective effect so as to avoid any possibility of misstatement with regard to past years results in a surplus or deficiency, the same should be transferred to the general reserve through Profit and Loss Appropriation Account. Depreciation for the year under audit as calculated according to the new method, should be debited to the Profit and Loss Account.

- Change of rate. This does not call qualifying the report unless it materially affects the financial statements.

3.11 DEPRECIATION AUDIT

While undertaking depreciation audit, the auditor should pay attention to the following:

- Internal control. He should satisfy himself as to the adequacy and effectiveness of internal control as regards accounting, maintenance and safeguarding of fixed assets. He should also ascertain whether there is a proper distinction between capital and revenue expenditure on the assets. The aspect of physical security of the assets should not be ignored because exposure to the elements of nature or inadequate maintenance, may necessitate accelerated rate of depreciation. Insurance coverage of the asset should also be examined to ascertain its adequacy.

- Preliminary. He should discuss the depreciation and related fixed assets policies with the management and satisfy himself as to their soundness and efficacy to ensure a fair and regular allocation of cost over the life-time of the respective assets, in accordance with generally accepted methods consistently applied.

- Provision of depreciation. He should satisfy himself that all fixed assets, including additions during the year, are proper capital items, that they are is existence, and that they have been shown at cost less depreciation properly calculated as per a recognised method. The statute governing an enterprise may provide the basis for computation of depreciation. In the case of a company, for example, the Companies Act provides that provision of depreciation should be based on the remaining balance method, at the rates specified in the Act, or as per the corresponding straight line depreciation rates which would write off 95% of the original cost over the specified period. However, it may also adopt any other method if the required permission from the Central Government has been obtained. In case the company has proposed to distribute dividend, the auditor should ascertain whether depreciation in accordance with Sec.205 (2) has been provided.

For assets on hand from the beginning of the year, he should see whether depreciation has been provided according to a method consistently followed over the years, and whether there is any change in the method or rate. According to AS-6, “Depreciation Accounting” issued by the Institute of Chartered Accountants, a change in the method is required by statute, or for compliance with the accounting standard or for appropriate presentation of the financial statements. In any case, the auditor must ensure that the new method is an accepted one and duly authorized by a resolution of the Board. Also, that depreciation on the assets concerned has been recomputed under the new method from the respective dates of their acquisition and any surplus or deficit, as the case may be, has been transferred to the general reserves through the Profit and Loss Appropriation Account.

In case of assets acquired during the year, or used only for a part of the year, depreciation should be calculated prorate.

- Sale, demolition, of asset. Where an asset has been sold, discarded, destroyed or demolished during the year, an appropriate terminal deprecation, if any, should be included in the provision.

- Excess depreciation. The auditor's duty is only to see that depreciation provided on the assets is adequate and reasonable, by whatever approved method or rate it may be calculated. The amount calculated as per Sec.205 also refers to the minimum amount of depreciation and there is no bar on providing excess amount for the purpose. However, where this is the case, such excess over the actual requirement should be treated as a reserve.
- Disclosure. Total depreciation provided up to the end of the year should be clearly disclosed in Balance Sheet. Similarly, if there is a change in the method of depreciation, a note to that effect should be appended to the financial statements, quantifying the effect of the change on the profit/loss. In case such change has a material effect, the report may also accordingly be qualified.

3.12 IMPORTANT JUDICIAL PRONOUNCEMENTS ON DEPRECIATION

- **Lee v. Neuchatel Asphalte Co.** (1889)

If a company is formed to work a mine, it can declare and pay dividend to its shareholders without providing depreciation on the mine, being a wasting asset, if the Articles of the company do not contain anything to the contrary.

However, this judgement is not applicable in India in view of the express provision in Sec.205 to the effect that dividend can only by declared or paid out of the profits of the company, arrived at after providing depreciation on its depreciable assets. It is true that Schedule XIV to the Companies Act does not provide any rate of depreciation in the case of mines or quarries as such, but then Sec.205(2)(d) lays down that where in case of any assets there is no rate of depreciation provided in the Act, depreciation will have to be provided on a basis approved by the Central Government.

- **Crabtree v. Crabtree** (1912)

Depreciation need only be provided on plant and machinery if the manufacturing business of the enterprise is to continue for an indefinite period. In other words, if the business is to continue only for a limited period, provision of depreciation can be avoided.

However, this case is not applicable in India as Sec.205, which makes provision for depreciation compulsory before declaring or paying dividend, makes no discrimination on this account between a business which is to continue indefinitely and that which is to be closed down after a specified time.

3.13 AUDIT OF PROVISIONS AND RESERVES

According to Part III of Schedule VI to the Companies Act, a provision means" any amount written off or retained by way of providing for depreciation, renewal or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy." According to the "Statement on Auditing Practices" issued by the Institute of Chartered Accountants of India (ICAI), liabilities whose existence is certain but whose value is to be estimated, are to be regarded as "provisions". However, if provision for any liability is is excess of the amount which, in the opinion of the directors, is reasonably necessary for the purpose, such excess will be treated as a reserve, and not a provision.

3.13.1 Classification of provisions

Provisions may be classified as – (a) those which relate to known liabilities the amount of which cannot be determined with substantial accuracy: (b) those which relate to reduction in the value of assets; and (c) those which relate to contingent liabilities.

- Provision for known liabilities. Provision as to known liability may be with respect to taxation, dividend ,provident funds, gratuity, insurance, pension and similar staff benefit schemes. In the case of a company, provisions in respect of known liabilities are to be shown in the Balance sheet after " Current liabilities".
- Provision for reduction in value of assets. Provision for depreciation, renewals, or diminution in the value of assets will fall under this category. In the balance sheet, these are shown as a deduction from the value of particular assets with respect to which these have been created. Accordingly, provision for depreciation will be shown as a deduction from the cost of fixed assets, and provision for bad and doubtful debts, as a deduction from the amount of sundry debtors.
- Provision for contingent liabilities. According to AS – 4, "Contingencies and events occurring after the Balance sheet date" issued by the ICAI, a contingency is a condition or situation the ultimate outcome of which whether any gain or loss, will be known or determined only on the occurrence or non-occurrence of one or more uncertain future events. A provision for a contingent liability is to be distinguished from a provision for known liability. An important feature of a contingent liability is that it is marked by uncertainty which is not so in the case of a known liability. For example expiry of the useful life of an asset is certain and therefore provision for depreciation, even though based on an estimate is a provision for a known liability. In the case of a contingent liability, however the financial effects are to be determined by future events which may or may not occur. The following are the examples of contingent liabilities:

- Claims against the client-enterprise in regard to breach of contact or additional wages bonus or compensation.
- Liability in respect of party-paid shares of other companies held by the client.
- Indemnities in respect guarantees provided by the client in respect of third parties or own subsidiaries.
- Liability in respect of forward contracts for purchase or sale of commodities consequent to price fluctuations.
- Liability as to payment of arrears of dividend in the case of cumulative preference shares.
- Outstanding contractual obligations under plans of expansion or modernization of the enterprise.

3.13.2 Auditor's duty

- The estimates of the outcome and financial effect of the liability, whether known or not, should be carefully estimated. The auditor's past experience and knowledge of the enterprise under audit should help him to estimate the type and extent of any liability to be provided.
- He should seek assurance from the directors that adequate provision has been made in the financial statements in respect of all known liabilities.
- In appropriate circumstances, he should also obtain written confirmations from third parties as to representations made by the directors, for example, identification and ascertainment of contingent liabilities.
- He should carefully go through the minutes of the Board meetings and correspondence with legal advisors of the enterprise to determine the existence and quantum of claims which may be outstanding against the enterprise.
- The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations should be disclosed in the financial statements by way of a note, even where any loss on this account may not occur.
- A potential loss to the client may be reduced or avoided if a contingent liability is matched by a related counter – claim or claim against a third party. The amount of provision in such a case should be determined after taking into account the probable recovery under the claim.
- According to AS-4, "Contingencies and Events Occurring after the Balance Sheet Date," issued by the ICAI, provisions for contingencies are not justified in respect of unspecified business risks, as they do not relate to conditions or situations existing at the Balance Sheet date.

- If there is an accruing liability for gratuity, an adequate provision for the same on the basis of figures supplied by the management should be made. An exact computation of this liability is dependent on determination of various factors like life expectancy of employees, rate of staff turnover, prevailing rate of interest etc. Reference should also be made to the "Statement on the Treatment of Retirement Gratuity in Accounts" issued by the Institute of Chartered Accountants of India.

3.14 RESERVE

A reserve is, by its very nature, a fund which is created and maintained for the purpose of being drawn upon in future. It is created for use or application in a future contingency, properly anticipated as likely or certain.

The term "reserve" has not been defined in the Companies Act except negatively, in the sense that is "shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability (Part III of Schedule VI to the Act)." In other words, profits retained in the business and not possessing any attributes of a provision, are to be treated as a reserve. Where a provision has been made in excess of what is considered a s reasonably necessary, the excess amount is also to be treated as a reserve.

Existence of profits after due provision of all chargeable expenses and losses is a pre-condition for creation of a reserve. In this respect, a reserve is to be distinguished from a provision, which is required to be created even when there are little or no profits, because then alone the results of operations of the business will be fairly reflected.

A reserve may be created for specific or general purpose. While in the year of its creation, the sum of a reserve is not available for distribution of dividend, the aggregate sum of past years' reserves may be appropriated for the purposes of dividend if the Board of directors passes a resolution to that effect, and if the reserve from which the appropriation is to be made is not a capital reserve. This is because reserves are at the disposal of the business and they are not meant for meeting any future specific losses or expenses.

3.14.1 Kinds of reserves

Reserves may be classified as capital and revenue reserves. Based on the purpose of their creation, they may also be classified as specific and general reserves.

The term "fund" in relation to any reserve should be used only where such reserve is represented by specifically earmarked investments.

Capital reserve

Capital reserve has been defined in Part III of Schedule VI to the Companies Act, as not including "any amount regarded as free fro distribution through the Profit and Loss Account.

A capital reserve is generally created out profits or gains of a capital nature, such as:

- Capital gains i.e., profit on sale of capital assets.
- Premium on issue of shares and debentures.
- Profits prior to incorporation.
- Profit on revaluation of assets and liabilities.
- Profit on redemption of debentures, etc.
- Amount utilized out of profits to redeem preference shares.
- Profit on forfeiture of shares.

In this respect, it is different from a revenue reserve which is created only out of revenue profits.

But there is no bar to creation of a capital reserve out of operating profits if the Articles of the company so provide and the Board of directors so decide. For example, it is a general practice to create Debentures Redemption Reserve, which is a capital reserve, through appropriation of revenue profits. Moreover, there are certain reserves, e.g., Development Reserve, which have the characteristics of a capital reserve to begin with, but which become a revenue reserve with the passage of time or upon fulfillment of certain conditions.

Being created out of capital profits which are generally not available for distribution to the shareholders, capital reserve is not applied for purpose of dividend. It is used mainly for writing off of capital losses or losses of an abnormal nature. However, at the discretion of the Board of directors, the prohibition on its distribution as dividend may be lifted under exceptional circumstances.

3.14.2 Distinction between Provision and Reserve

Provision	Reserve
It is an amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets, or for any known liability the amount of which cannot be accurately determined.	It does not include any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets or for a known but unquantified liability.

It is a charge on the profits without which true and fair profit or loss of the business cannot be arrived at.	It is an appropriation of profits and does not require to be created to ascertain true And fair profit or loss.
It marks a provision for expenses or losses of the business. Existence of profits is not a precondition for its creation.	It marks retention of profits in the business. Existence of profits is a necessary pre-condition for its creation.
It cannot be applied for purposes other than those for which it has been created.	Being undistributed profit it can be used even for purposes other than those for which it has been created.

Auditor's duty. The auditor should ensure that capital reserve is shown separately in the Balance Sheet and not mixed up with any other reserve or general reserve. He should also see that it is created out of capital profits only, and where operating profits have been appropriated for the purpose, there is proper authorization form the Board of directors in this behalf. Further, he should ascertain that it is used only for the purpose of writing off capital or abnormal losses, and where it is used for purposes of dividend, the provisions of the Articles and Companies Act are duly complied with.

Revenue reserve

Revenue reserve implies "any reserve other than a capital reserve." Such a reserve is built out of ordinary trading or revenue profits for general or specific purposes such as redemption of preference shares or debentures, replacement of assets, etc.

Specific reserve

A specific reserve is one which is tied down to any specific matter or purpose of the company. Like any other reserve, it is created by appropriation of profits. Ordinarily, it is not available for purposes other than those for which it has been created. Examples of a specific reserve are:

- Dividend Equalisation Reserve.
- Investment Fluctuation Reserve.
- Reserve for Redemption of Debentures.
- Plant Replacement Reserve.

Though earmarked for a specific purpose, in certain circumstances and at the discretion of the Board of directors, a specific reserve may also be used for purposes other than the one of its creation. Thus, upon a resolution of the Board, Plant Replacement Reserve may be used for payment of dividend, or Dividend Equalisation Reserve may be used to absorb the effects or price fluctuations as regards investments. But the basis for such altered use is the discretion of the Board which again is subject to limitations. For example a reserve

created for the purpose of redemption of debentures under a Debentures Trust Deed, cannot be used any other purpose.

Auditor's duty. The auditor must ascertain whether the reserve is adequate and reasonable having regard to the objects for which it has been created, though the extent of adequacy and reasonableness will differ from business to business.

General or free reserve

A general reserve is created by appropriation of profits to act as a cushion to absorb the adverse effects of a certain or uncertain business situation likely to arise in future. It also ensures additional working capital and goes to add to the financial worth and reputation of the business.
A general reserve is not tied down to any specific matter or purpose. At the discretion of the Board of directors, it can be used for any purpose, including payment of dividends. It is the general reserve which is used to equalize the rate of dividend in the years of low profits. And when profits are excessive, creation of general reserve serves to conceal the profits for use during lean years.

Auditor's duty. Creation of a general reserve is not a legal necessity. Only a management with foresight and a sense of judgement will create and maintain it. This considerably reduces the work on an auditor in the sense that he has only to ascertain whether the creation of general reserve is in the interest of the business and that if the company has framed certain rules in this regard, they are duly adhered to . In case his advice is solicited on the question of adequacy or reasonableness of the reserve, he may oblige but he should not on his own after any advice as to creation of a reserve, particularly so if profits are inadequate.

Secret or internal reserve

A secret reserve is one the existence of which is kept a secret and not disclosed on the face of the Balance Sheet. It represents an excess of the value of assets over liabilities and denotes concealment of profits by means of either understatement of assets or overstatement of liabilities.

Existence of a secret reserve strengthens the financial viability of the business and promotes confidence and stability, because it is often used to swell profits and equalise dividend when the going is not good. However, the Companies Act, which requires the financial statements to reflect a true and fair, view of the financial position and results of operations of the company, impliedly prohibits the creation of secret reserves, unless the company has been expressly exempt from the provisions of Schedule VI, as in the case of a banking, insurance and electric supply company.

How secret reserve is created. Secret reserve will come into existence by means of any of the following:

- Understatement of assets, i.e., showing the assets at a value below their real worth (Stock –in-trade, good will, etc.) or making excessive provision for bad and doubtful debts or depreciation.
- Ignoring permanent appreciation in the value of assets.
- Overstatement of liabilities, including contingent liabilities.
- Supressing accrued incomes and prepaid expenses.
- Treating capital expenditure as revenue.
- Making provision for expenses and losses in excess of their incidence.

Merits. Creation of secret reserve is for the general good of the company in the sense that it makes it financially stronger and capable of developing and surviving without outside help.

- Secrecy is a necessary condition of commercial success. A secret reserve helps to show the business situation as less favourable than the ground realities, and this enables the company to avoid competition from entrepreneurs who are ever in search of profitable lines.
- A less attractive picture of the working in financial statements also saves the company form State intervention.
- A secret reserve helps to reinforce trading profits in the years when the going is not good. Thus, it may be used to equalise dividends.
- Lack of fluctuation in the dividend rate leads to stability in the share values.

Demerits. As a secret reserve owes its existence to under valuation of assets and overstatement of liabilities, it leads to distortion in the financial statements which do not depict a true and fair picture either of the profit or loss, or of the affairs of the business.

- As creation of a secret reserve goes to diminish the profits available for distribution of dividend, the shareholders are denied their legitimate due.
- Disclosure of low profits and consequent declaration of a low rate of dividend, may adversely affect the share value.
- The fact of creation, existence or use of secret reserve is known only to the directors and top managerial personnel of the company who may utilize their vantage positions to make illegitimate gains through buying and selling of shares.
- A secret reserve accumulated in past years may be used to push up profits in years when the company is faring badly, and this may mislead the shareholders and the general public into believing that the company management is making profits when such is not, in fact, the case.

- While the fact of existence or use of a secret reserve is concealed by the company management in the belief that such concealment is in the interest of the company, the shareholders and investors are deprived of vital information to enable them to estimate the real value of shares.
- Building of secret reserve is also detrimental to the interests of the consumers and employees of the company and to the tax revenue.

Auditor's duty. While creation of secret reserve is in the overall interest of the company, the Companies Act prohibits it except in the case of a banking, insurance and electric supply company. For the auditor of a company, which is not legally permitted to create a secret reserve, existence of such reserve may create a dilemma.

This is because, if the auditor reports the existence of secret reserve to the shareholders of the company, the vital secrecy about such reserve will be lost, the company will not be able to draw on this valuable reservoir in time of need, and this will be detrimental to the interests of the shareholders themselves. On the other hand, if he decides to turn a blind eye to the existence of such reserve and doest not make any mention of it in his report, he may invite the penalty for rendering his opinion on the Balance Sheet and Profit and Loss Account even though they are incorrect in material respects. In the case of Royal Mail Steam Packet Company, which set the tone for development of opinion in regard to secret reserves, the auditors were charges with lending approval to the use of secret reserve so as to alter and reverse the apparent trend of trading results in the mind of an uninstructed reader of the financial statements of the company. Though the trial resulted in an acquittal, the desirability of fullest practicable disclosure in the published accounts has since been increasingly emphasized.

In India, the auditor is under a legal duty to ensure that the Balance Sheet and the Profit and Loss Account of the Company under audit are drawn up in conformity with the provisions of Schedule VI (Section 211(1)), unless it has been specifically exempted from the application of this provision as in the case of banking, insurance and electric and electric supply companies (Sec.211(3)).

Thus, however beneficial it may be for the company to create a secret reserve, the auditor must disclose its existence in his report because he is duty bound to sate whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts….. give true and fair view, in the case of balance sheet, of the state of the company's affairs as at the end of its financial year, and in the case of profit and loss account, of the profit and loss for its financial year.

Reserve fund

According to Part I of Schedule VI to the Companies Act, "The word 'fund' in relation to any reserve should be used only where such reserve is specifically represented by earmarked securities. "Thus, a reserve fund means the amount standing to the credit of a

reserve which has been applied for the purchase of easily realisable securities outside the business.

However, in certain cases, there may be a statutory requirement or a provision in the Memorandum or Articles of the company, to the effect that a reserve be described as a fund. For example, Capital Redemption Reserve Fund, thought it may not be represented by actual investments in outside securities, is required to be described as a fund only.

In any case, a reserve fund, like any other reserve, goes to strengthen the financial position of the company irrespective of whether it is for specific or general purpose.

Auditor's duty. The auditor should ascertain that a reserve fund is separately shown in the Balance Sheet and that it is represented by earmarked securities (or other assets) realisable as and when required, at an amount which is not less than the sum of the reserve fund.

Sinking fund

A sinking fund is a fund established for the future redemption of debt or liability or for replacement of an asset. Thus, it may be set up in respect of :

- Redemption of loans or debentures.
- Replacement of an asset of depreciating nature, such as, plant and machinery.
- Redemption of wasting asset, such as, a mine.
- Renewal of a lease.

It is generally represented by specifically earmarked investments or other assets which are realized when necessary, and the funds are then used to redeem the liability or to replace the asset.

A sinking fund is created by appropriating a part of the profits each year with the object of their investment is especially earmarked securities so that in certain circumstances or, more particularly, on a specified date, a certain sum may be available to pay liability or to acquire an asset.

The procedure for creation of a sinking fund is simple. A portion of the yearly profits are credited to the Sinking Fund Account. The amount is invested in earmarked securities which results in a debit entry in the Sinking Fund Investments Account. Interest earned on such investments is credited to the Sinking Fund Account and when reinvested in the same securities, it goes to the debit of the Sinking Fund Investments Account.

There is a difference in accounting treatment between a sinking fund created for redemption of a liability and a fund for replacement of an asset. In the first case, it marks an appropriation of profit and, therefore, the annual sum is debited to Profit and Loss Appropriation Account. Debenture Redemption Fund, which is created to ensure

availability for funds on the date of redemption, is one such fund. As against this, a sinking fund created to replace an existing asset marks a charge on profits because it provides against a loss which, when it arises, will be chargeable to profits. As such, for this purpose the Profit and Loss Account is debited every year.

Yet another point of difference is that in the case of sinking fund created for the redemption of a liability, the liability is redeemed on the due date out of cash realized form sale of investments, whereas accumulated profits credited to the Sinking Fund Account remain intact. This account is therefore closed by transfer to the General Reserve Account. As against this, in the case of sinking fund created for replacement of an asset, while the new asset is purchased out of cash realized from the sale of investments, the Sinking Fund Account is closed by transfer to the Old Asst Account, which has been shown in the Balance Sheet at the cost of acquisition.

Auditor's duty. The auditor should first familiarize himself with the terms and conditions of creation of a sinking fund, and ensure that these are being duly adhered to. For example, in the case of creation of Debentures Redemption Fund under a trust deed, he should see that all its requirements are being met.

3.14.3 Distinction between General and Specific Reserve

General Reserve	Specific Reserve
It is for general purposes and not tied down to any specific purpose or matter.	It is tied down to a specific purpose
It is created by appropriation of profits.	It is created by appropriation of profits.
It is created to strengthen the financial position of the business when profits are adequate.	It is created to meet a future liability or loss, such as redemption of debentures.
Being retained profits, it can be used for distribution of dividend or for any other purpose at the discretion of the Board of directors.	Though representing undistributed profits, it is generally not used for any purpose other than the one of its creation. But at the discretion of the Board, it may also be used for any Other purpose, though in certain cases, like Debentures Redemption Reserve under Trust Deed, this cannot be done.

If the sums are to be invested in especially earmarked securities, he should ensure that this is in fact being done. He should also see that the sums set aside for the redemption of

liabilities, or for acquisition of a new asset are adequate, and for this purpose, he should go through the calculations as to the amount to be invested and the rate of yield. When the securities are realized on the due date, he should see that any profit or loss on realization or redemption of liability or acquisition of a new asset is carried to the Sinking Fund Account and not to the Profit and Loss Account.

3.15 IMPORTANT JUDICIAL PRONOUNCEMENTS ON DEPRECIATION, RESERVES, ETC.,

- Verner v. General Commercial Investment Trust Ltd. (1894)

The broad question raised in this case was whether a company can pay dividend out of profits attributable to its investments without first providing for depreciation in the capital value of some of its investments. The Court held that a company cannot be compelled in all cases to recoup losses shown by the capital account. Admitting that capital must not be treated as profit, the Court said that if the company has any assets which are not its capital, then there is nothing to prevent it from distributing them as dividend to the shareholders.

From the auditor's point of view, there is an important observation is this judgement, namely: "Fixed capital may be sunk and lost, and yet the excess of current receipts over current payments may be divided; but floating or circulating capital must be kept, up, as otherwise it will enter and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it, will be contrary to law."

Lee v. Neuchatel Asphalte Co. Ltd. (1889)
The company was formed specially to acquire a concession to work and get bituminous rock in Switzerland. There was a provision in the Articles of the company to the effect that the directors could, before recommending any dividend, create a reserve fund to meet contingencies, or to qualise dividends, or for repairs and maintenance, but they were not bound to reserve money for the renewal or replacing of any lese, or the company's interest in any concession.

An ordinary shareholders appealed to the court to restrain the company from declaring dividend on its preference shares on the plea that – (a) principal part of the company's capital was lost; (b) the property of the company was not sufficient to make good it share capital; and (c) the deficiency in the capital should be made good before declaration of any dividend.

The court held that "if a company is formed to acquire or work property of a wasting nature, e.g., a mine, quarry or patent, the capital expended in acquiring the property may be regarded as sunk and gone and if the company retains assets sufficient to pay its debts, any excess of money obtained by working the sufficient to pay its debts, any excess of money obtained by working the property over the cost of working it, may be divided

among the shareholders. "It was also said in the judgement that "The nominal share capital is diminished in value by reason of causes over which the company has no control, or by reason of its inherent nature. The diminution need not ….. be made good out of revenue.

Newton v. Birmingham Small Arms Co. Ltd (1985)

The Articles of the company were latered by special resolution enabling the directors to set up an internal reserve fund (secret reserve) in addition to the already existing reserve fund. It was provided that the secret reserve was not to be disclosed in the Balance sheet and that the directors were not required to give any information to the shareholders as to the amount, investment, or application thereof which was to be within "absolute discretion" of the directors only. However, the auditors were required to see that the secret reserve was applied for the purpose of the company thought they were not to disclose any information with regard to the same to the shareholders.

Upon a suit by a shareholder against the said resolution, the Court held that while the company can provide for non –disclosure of secret reserve in the Balance Sheet, it cannot prevent the auditor form doing something which he is legally required to do, viz., to report the true and correct state of the company's affairs to the shareholders. The resolution was accordingly held to be ultra virus and invalid.

Royal Mail Steam Packet Company, reported as Rex v. Lord Kylsant and Another(1931)

The gross earning of the company were not enough even to cover its expenses. Despite this, the company was showing a surplus in its published accounts and declaring dividend by means of drawing on a secret reserve which it had created in the past years through excessive provision for tax liability.

The Inland Revenue authorities brought a case against the auditors alleging that they had approved the use of secret reserve for deliberately false representation to the shareholders that the company was making a trading profit, while in fact it was making a trading loss.

While the trial ended in an acquittal for the auditors, the Court made some very pertinent observations as the duty of the auditor vis-à-vis secret reserve. According to it, there may be some justification for the maintenance of a secret reserve only "if the fact that there was such reserve was clearly specified somewhere in the report, so that the shareholders could know, and if the majority of them desired to insist on its disclosure and its utilization, they could do so." True, the auditor is not concerned with the question of policy and it is not for him to say whether a dividend is properly or improperly declared, but if he finds that there is something in the accounts to which he ought to draw attention of the shareholders, it is his duty to do so. In such a case, either he should not sign the certificate at all, or he should sign it with some qualification such as the circumstances may require. In a nutshell, the auditor must disclose the existence of a secret reserve in his report.

Wilmer v. McNamara & Co. Ltd (1895)

The company, which has been providing adequate depreciation in respect of its fixed assets in past years, passed a resolution at its general meeting to pay dividend to its preference shareholders without providing depreciation for the current year.

Upon a plea by the equity shareholders to restrain the company from implementing the said resolution, the Court refused to intervene, saying that the company was well within its right to pay dividend from its current year's profit without providing depreciation.

Brown v. Gaumount British Picture Corporation Ltd. (1937)

The company had holdings in its subsidiaries which had depreciated considerably. The Balance Sheet of the company showed a large reserve in the form of Share Premium Account, though the consolidated Balance Sheet of the group showed heavy losses as incurred by the subsidiaries.

On the question whether the company could pay dividend on its cumulative preference shares without providing for the loss on holdings, the Court, maintaining the principle as lay down in Lee v. Neuchatel Asphaltel Co. Ltd, held that it could do so.

Review Questions:

1. Define verification of assets and its importance with example.
2. What are the general principles of verification and valuation of assets?
3. What are the auditor's duty with regard to verification and valuation of assets?
4. As an auditor of the company how would you verify the following liabilities?
   1. Sundry creditors, 2. Bills payable, and 3. Contingent liabilities.
5. Explain the procedure for the verification of inventories.
6. Elaborate the Depreciation audit with its various types.
7. Explain the audit of provisions and reserves.

UNIT- IV

LESSON-4
AUDITORS

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4.18 CHARACTERISTICS OF A GOOD REPORT

4.0 AIMS AND OBJECTIVES

In this unit the appointment of auditors, procedures and removal of auditors are explained. Qualifications of auditor, and ceiling of auditors, remuneration of auditors are explained. Then rights of company auditor, duties of company auditors are explained. Joint auditor, branch auditor and audit with shares are explained. Finally how to write an audit report and good characteristics of the audit report are explained.

4.1 INTRODUCTION

COMPANY AUDIT APPOINMENT AND REMOVAL OF AUDITORS

The auditor, like a doctor or a lawyer, is a professiona1 person, duly qualified and offering his services as expert to the general public. Even though he belongs to the youngest of the professions, he is trusted by all concerned for his integrity, independence and professional

competence. In the case of a company, examination of its affairs by the auditor is practically the only safeguard available to the shareholders against the enterprise being run in an unbusiness - like manner, or money being misapplied or misappropriated without· their knowing anything about it *(Deputy Secretary, Government of India, Ministry of Finance* v. *S.N. Gupta* A.I.R. 1955 Cal. 414).

Provisions as to auditor in the Companies Act. The provisions concerning the company auditor are contained in Sees. 224 to 233B dealing with matters as follows:

Sec. 224 : Appointment and remuneration of auditor.

Sec. 224A : Appointment of auditor by special resolution in certain cases.

Sec.225 : Resolutions for appointing or removing auditors.

Sec.226 : Qualifications and disqualifications of auditors.

Sec.227 : Powers and duties of auditors.

Sec.228 : Audit of accounts of any branch office of a company.

Sec.229 : Signature of audit report, etc.

Sec.230 : Reading and inspection of auditor's report.

Sec.231 : Right of auditor to attend general meeting.

Sec.232 : Penalty for non-compliance with Sec. 225 to 231.

Sec.233 : Penalty for non-compliance by auditor with Sec. 227 and 229.

Sec.233A : Power of Central Government to direct special audit in certain cases.

Sec. 233B: Audit of cost accounts in certain cases.

4.2 QUALIFICATIONS OF AUDITORS [SEC. 226(1) AND (2)]

The object of the provisions as to qualification of the auditors is. to ensure that only persons of proven· worth and standing and under the discipline of a statutory body, are appointed as auditors. . Accordingly only the following persons will be competent to be appointed as auditors of a company.

- *Practicing chartered accountants [*Sec~226(1)]. A person shall be qualified for appointment as auditor of a company if he is a chartered accountant within the meaning of the Chartered Accountants Act of 1949.

A chartered accountant means a person who is "a member of the Institute of Chartered Accountants of India. He will be "deemed to be in practice" when, individually or in partnership with any other chartered accountants in practice, he, in return for consideration received Otto be received -

(a) *engages* himself in the practice of accountancy;

(b) *offers* to perform or *performs* the services involving the auditing or verification of financial transactions, books, accounts or records, or the preparation, verification or certification of financial accounting and related statements, or holds himself out to the public as an accountant; or

(c) *renders* professional services or assistance in or about mattes of principle or detail relating to accounting procedure or the recording, presentation or certification of financial facts or data ; or

(d) *renders* such services as, in the opinion of the council are, or may be, rendered by a chartered accountant in practice.

- **Partnership firm as auditor.** In the case of a firm, if all its partners practising in India are qualified for appointment as auditors, it may be appointed by its *firm name* to be auditor of a company. In such a case, any of its practising partners can act in the name of the rum. However, an individual chartered accountant, being the sole proprietor (of, say, A & Co.), *cannot* be appointed auditor in the name of the firm

- **Certified auditors** [Sec. 226(2)]. Apart from the practising chartered accountants, a person holding a certificate under the Restricted Auditor's Certificate (Part B States) Rules, 1956, is also qualified to be appointed as auditor of a company. Such certified auditors are subject to the rules framed in this behalf by the Central Government.

4.3 DISQUALIFICATION OF AUDITOR [SEC. 226(3), (4) AND (5)]

4.3.1 Statutory Disqualifications

The following persons shall not be qualified for appointment as auditors of a company:

(a) A *body corporate*

(b) An *officer 'employee* of the company.

(c) A person who is a *partner* or who is in the *employment* of any officer or employee of the company. .

(d) A person who is *indebted* to the company for an amount exceeding Rs.1,OOO, or who has given any guarantee of any third person to the company for an amount exceeding Rs.1,000 [Sec. 226(3)] .

4.3.2 Other disqualifications. According to' Sec. 226(4), a person shall . not be qualified for appointment as auditor of a company if he is statutorily disqualified for appointment as auditor of *any other body corporate* which is -

(a) a *subsidiary* of that company; or .

(b) *the holding company of the company; or*

(c) a *subsidiary of* that company's holding *company;* or .

(d) if he would ~ so disqualified if that body corporate were a *company.* Further, if the auditor already holds appointment as auditor in the specified number of companies as per Sec. 224(I-B), he will be disqualified for further appointment as auditor of any other company.

Where an auditor incurs any of the above disqualifications after his appointment, he will be deemed to have vacated his office [Sec. 226(5)].

Illustrations: • X is the sole proprietor of X & Co., chartered accountants. X *cannot be* appointed auditor of a company in the name of· the firm.

- X & Co., a firm of chartered accountant$, is appointed as auditor of a company in the name of the firm. *Y,* who is a partner of the firm, is related to one of the directors of the' company. In this case, the firm is *qualified* to be appointed auditor of the company. However, if the auditor's remuneration exceeds the limits laid down in Sec. 314, a special resolution and the Central Government's permission would be necessary.
- X, a chartered accountant. is a director of *A* Ltd. which is a subsidiary of *B.* Ltd. The Board of directors of *B* Ltd. proposes to appoint X as the auditor of *B* Ltd. *X* is *not* qualified to be appointed as auditor of *B* Ltd. because a person who is not qualified to be the auditor of a company would also not be qualified to be auditor of such company's subsidiary, or holding company.
- X & Co., a *rum* of chartered accountants, is appointed· auditors of a public company. Besides, it is entrusted with the work of preparing a feasibility report as to modernisation of the working of the sales and accounts departments of the company. The appointment does not suffer from any infirmity and is *valid.*
- X, a chartered accountant, is proposed to be appointed the auditor of a company running a chain of departmental stores. X is a credit cardholder of the company and is permitted 'to make credit purchases up to a sum of Rs. 5,000 at any time and to clear the bills within ·three months of the date of purchase. X is *not* qualified to be appointed as auditor of the company unless he ensures that his indebtedness to the company at any time does not exceed Rs. 1,000.

4.3.3 Rationale of disqualifications

The disqualifications as prescribed have manifold objects. For example, a body corporate, which has a separate entity from its members, has been disqualified for appointment as auditor so as to ensure that the auditor may not escape personal liability to his client, to that in privacy, and to third parties. Disqualifications under *(b), (c)* and *(d)* are meant to preserve the auditor's independence. As observed in the. "Compendium Of Notes" issued by the Research Committee of the Institute of Chartered Accountants of India, "professional integrity and independence is an initial characteristic of all learned professions, but it is all the more so in the case of the accounting 'profession". Independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who has engaged him, or to his own self- interest. .

Independence. In the case of an auditor assumes special .significance also because though" theoretically, he is apP9mted by the shareholders in the general meeting of the company, in reality he is an appointee of the directors of the company. Thus, if he is an employee of the company, or a partner or an employee of any officer or employee, (if be owes the company an amount exceeding Rs.1,000, or has stood surety for someone owing the company a , similar amount, his independence is bound to be compromised and he would not be able freely and fearlessly to express his opinion as to the truth and fairness of the assertions made by the management in the financial statements. If an auditor purchases goods and services from a company of which he is an auditor, and if the amount outstanding against him exceeds Rs.1,000, then irrespective of the nature of the purchase or credit allowed to other customers, he will incur the' 9isqualification under *(d)* above. Similarly, if a firm, of which the auditor is a partner, is indebted to the company under audit for a sum exceeding RS.1,000, the disqualification will apply to the auditor.

The disqualification prescribed in Sec. 224 (I-B), to be discussed later in this chapter, seeks to achieve dissociation of auditors from groups of companies, so that they are not tempted to hide the management's shortcomings from the shareholders.

'Is the auditor disqualified to act as such if a relative of his has a substantial, interest in the company under audit? Not really. But in such a case, while expressing his opinion on the financial statements of the company, he should disclose his interest in the report. Failure to make such a disclosure would be 'misconduct" under the Chartered Accountants Act.

4.4 APPOINTMENT OF AUDITORS

The provisions relating to the appointment of auditor are as follows:

Appointment of first auditor [Sec. 224(5)],

The first auditors(s) .of a company *shall* be appointed by the *Board of directors* within *One month* of the date of *registration* of the company. The auditor so appointed *shall* hold office *until the' conclusion* of the *first annual general meeting.*

Appointment of the first auditors should be by a valid resolution at the Board meeting. Merely naming them in the Articles will *not* be recognised as appointment under the Act.

In case the Board does *not* exercise its power in this regard, the first auditors(s) shall be appointed by the company in its general meeting. But whether appointed by the Board or by the company, information to the' first auditor(s) about the fact of his appointment as such is *not* a necessary condition. The first auditor(s) is also *not* required to inform the Registrar about his acceptance or refusal of the said appointment.

4.4.1 Appointment by company, i.e., shareholders [Sec. 224(1)]

"Every company *shall,* at each annual general meeting, appoint auditor(s) to hold office *from* the conclusion of that meeting *until* the conclusion of the next annual general

meeting, and shall, within *seven* days of the appointment give *intimation* thereof to every auditor so appointed.

Ordinarily, the power to appoint auditor(s) lies with the shareholders of the company in general meeting. Only in exceptional circumstances can the appointment be made by the Board, such as, appointment of the first auditors, or auditors to fill casual vacancy or appointment by the Central Government (where the company has failed to exercise its power to appoint).

Duration of appointment: The appointment is valid only from the conclusion or one meeting up to the conclusion of the next meeting. Where an auditor is appointed for any other period, his functioning during the shortened period will not be lawful and he shall not be entitled to any remuneration for the same. But if the next annual general meeting is' not held within the period prescribed by Sec. 166, the auditor(s) shall continue to hold office till such meeting is held and concluded. Where such meeting is adjourned to a later date, the auditor(s) shall hold office till the conclusion of the adjourned meeting.

The term of an auditor's appointment being so fixed, it is clear that his appointment is not with reference to the audit of accounts of any particular year. In other words, his office shall stand vacated at the conclusion of the next general meeting even if such meeting has been called before the completion of audit and, consequently, audited accounts have *not* been presented at the meeting and the auditor has *not* been able to discharge his statutory obligation of reporting on the accounts as per Sec. 227. This means that if a company fears disclosure of any inconvenient information by its present auditor at the next general meeting, it may manipulate' his exit by holding the general meeting. *before* the completion of audit, and then appoint an auditor of its liking at that meeting to complete the audit. But it needs to& noted that to report on the accounts is a statutory obligation of an auditor, and in a situation like this he can report on the accounts even if his audit is' not yet complete, or the final accounts have not yet been prepared.

- *Certificate from auditor in terms of Sec. 224(1-B).* Before any appointment/reappointment of the auditor(s) in the annual general meeting, the company is required to obtain a certificate from him that in the case of his appointment, there will be *no* violation as regards the ceiling on auditorships laid downinSec.224(1-B).
- *Auditor to intimate his acceptance to Registrar* Within *thirty days* of the receipt of intimation from the company about his appointment, the auditor(s) shall inform the Registrar in writing about his acceptance or refusal of such appointment.

4.4.2 Reappointment of auditor [Sec. 224(3)]

Ordinarily, at any annual general meeting, the retiring auditor shall automatically be reappointed. Neither the Board nor the shareholders can refuse to reappoint him. However, in the following cases, the retiring auditor shall *not* be reappointed:

(a) if be is *not* qualified for reappointment;

(b) if he has given the company a *notice in writing* of his *unwillingness* to be reappointed ;

(c) if a *resolution* has been passed at the meeting - *(a) to appoint somebody other than him,'* or (b) *to provide expressly that he shall not be reappointed: or*

(d) if a *notice has* been given of any *resolution proposing the appointment of some other person in* the place of the retiring auditor. (Even if such resolution cannot be proceeded with by reason of the death, incapacity or disqualification of the person proposed to be appointed, the retiring' auditor shall not automatically be entitled to reappointment.)

Reappointment of the retiring auditor shall also not be made if he is already holding auditorship in the specified number of companies (Sec.244(1-B).

An auditor will cease to hold office on "becoming insolvent or insane. Though the Companies Act does not provide for a situation of this nature, it is not possible for an insolvent or insane person to hold the office of auditor. Even otherwise, under Secs. 8 and 20 of the Chartered Accountants Act, such a person is disqualified for having his name on the Register of Chartered Accountants.

4.4.3 Appointment by Central Government [Sec. 224(3)]

Where *at any general meeting, no auditor is appointed or reappointed,* the Central Government *may* appoint a person to fill the vacancy. This power of the Central Government is as a consequence of the company's failure to appoint an auditor at its annual general meeting. In such a case, the company is required, within *seven days* of its failure to appoint or reappoint an auditor, to apply to the Regional Director to whom the Central Government's power to appoint an' auditor in such an even has been delegated under Sec. 637.

The said application must disclose in sufficient detail the reasons why the company could not appoint the auditor at its general meeting. In the case of default, the company and every officer of the company who is in default shall be punishable with a fine which may extend to Rs. 500 [Sec. 224(4)].

4.4.4 Appointment in case of casual vacancy [Sec. 224(6)]

The Board of directors *may* fill any casual vacancy in the office of the auditor. But while any such vacancy continues, the remaining auditor(s),if any, may act. However, where any casual vacancy is caused by the *resignation* of an auditor during the term of his appointment, the vacancy shall only be filled by the *company* at the *general meeting.*

The term "casual vacancy" has not been defined in the Act. In its natural connotation, it means vacancy in the office. of auditor resulting from accidental or fortuitous circumstances such as death, incapacity or disqualification of the auditor. But it implies that the person who had been appointed to, and holding the office of auditor has ceased to continue as such.

Refusal of a person to accept his appointment or reappointment as auditor will not result in casual vacancy ; and the Board· has *no* power to fill such vacancy even if the shareholders have, at the time of appointing or reappointing the auditor but anticipating his refusal to accept such appointment. authorised the Board to fill the vacancy caused by such refusal. The correct thing in such a case will be for the shareholders to fill the vacancy in the general meeting.

4.4.5 Appointment by special resolution (Sec. 224A)

In the case of a company, in which not less than 25% of the subscribed share capital is singly or jointly held by -

(a) a public financial institution or a Government company, or the Central Government, or any State Government; or

(b) any financial or other institution established by any Provincial or State Act, in which a State Government holds not less than 51% subscribed share capit1 or

(c) a nationalised bank: or an insurance company carrying on general insurance business, the *appointment* or *reappointment* (at each annual general meeting) of an auditors(s) shall be made by a *special resolution.*

Public financial institutional referred to in *(a)* shall be - *(i)* Industrial Credit and Investment Corporation of India; *(ii)* Industrial Finance Corporation of India; *(iii)* Industrial Development Bank of India; *(iv)* Life Insurance Corporation of India; and *(v)* Unit Trust of India. Other financial institutions may also be notified as such by the Central Government if 51 % or more of their capital is held or controlled by the Central Government.

Where a nationalised bank holds shares in its own name by way of security for loans advanced by it, such shares will be taken into account for computing 25% of the company's subscribed capital.

It is noteworthy that for appointment of an auditor by a special resolution, 25% of the *subscribed capital* (not only equity capital) is required to be held by the above said institutions. This means that even preference shares held by these institutions will entitle them to have a say in: the matter of appointment of auditors of the company.

Where a company, to which Sec. 224A is applicable, does not pass a *special resolution* for the appointment of auditor at its annual general meeting, it will be assumed that the company is without an auditor. In such a case, the Central Government shall have power to fill the vacancy under Sec. 224(3).

If 25% of the subscribed capital of the company is held by the specified institution *on* the *date of the annual general meeting* at which the special resolution is to be passed, it will suffice to attract the provisions of Sec. 224A. Appointment of auditors of Government companies (Sec. 619) Appointment of auditors in the case of a government company is subject to the provisions of Sec. 619 which *overrides* Secs 224 to 233 dealing with appointment, etc., of the auditors in the case of non- Government companies.

Accordingly, "auditor of a Government company *shall* be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor-General of India". But while tendering advice or making the appointment; effect shall be given to the provisions relating to ceiling on company audits as per Sec. 224(1-B) and (l-C).

4.4.6 Appointment of auditor of other companies [Sec. 619B]

Provisions of Sec. 619 shall also apply in the case a company in which *not less than* 51 % *of the paid-up share capital* is held, whether *singly* or *jointly, by-*

(a) the Central Government and one or more Government companies;

(b) any State Government(s) and one Or more Government companies ;

(c) the Central Government, one or more State Governments, and one or more Government companies; .

(d) the Central Government and one or more corporations owned or controlled by the Central Government; .

(e) the Central Government, one or more State Governments, and one or more corporations owned or controlled by the Central, Government;

(f) one or more corporations owned or controlled . by the Central Government or the State Government·; and .

(g) more than one Government company.

In other words, auditor for such a company shall be appointed by the Central Government on the advice of the Comptroller and Auditor-General of India.

It is for the company falling under this Section to comply with the provisions thereof. In case of default, the appointment made by it shall be void *ab initio.*

4.5 CEILING, ON NUMBER OF AUDITS [SEC. 224(1-B)]

Sec. 224(1-B) introduces a ceiling on the number of companies of which a person or a firm could be the auditor. It says, *"no company* or *its Board of directors* shall appoint or reappoint *any person* (who is in *full time employment* elsewhere), or a *firm* as its auditor, *if such person, or firm is, at the date of such appointment or re-appointment, holding appointments as auditor of the specified number* of companies, *or more than the specified number* of companies".

The ceiling has a two-fold object first, to bring about, dissociation of auditors from groups of companies so that they might not have temptation to shield the shortcomings of the managements from the shareholders; secondly, to achieve a more equitable distribution of audit-work amongst the different auditors, so that the younger sections of the audit profession may have a better chance of advancement in the profession.

"Specified number" defined

The *specified number* of companies in the case of an auditor or firm of auditors will be as follows:

(a) in the case of any person who holds appointment as auditor of a *number of companies* and *no such company has* a *paid-up capital* of Rs. 25 lakhs or more - 20 *such, companies.* In the case of a firm of *auditors,* the specified number will be twenty companies per partner, who is *not* in full-time employment elsewhere.

(b) In- *any other case* - 20 *companies,* but subject to the condition that the number of companies with paid up share-capital of Rs. 25 lakhs or more shall not exceed ten (Expl. 1).

The computation of the specified number will be as follows:

- In the case of a firm of auditors, "specified number" shall mean specified number of companies per partner of the firm who is not in full time employment else where (First Proviso).

Illustration. A firm of auditors has three partners, A, B and C. None of the partners is an auditor of any company in his personal capacity, or as auditor of any other firm of auditors, or in full-time employment elsewhere. The specified number of company audits in the case of the firm will be sixty (i.e., 20×3), provided that the number of companies having a paid-up share, capital of Rs. 25 lakhs or more does not exceed thirty.

Illustration. A firm of auditors has three partners A, B and C. B holds full-time employment in a bank. The specified number of company audits in the case of the firm will be forty (i.e., 20 x 2), subject to the 'condition that the number of companies with a paid-up share capital of Rs. 25 lakhs or more, does not exceed twenty .

- If any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies which may betaken into account by all the firms *together,* in relation to *such* partner, shall *not* exceed the specified number of *twenty* in the aggregate, (Second Provision).

Illustration. A is a partner of AB & Co., which holds ten company audits, of which five are held by A alone. A is also a partner in AC & Co. A cannot hold more than fifteen company auditors (i.e., 20 - 5). Also, in the total specified umber of twenty company audits, the number of companies having paid-up share capital of Rs. 25 lakhs or more should not exceed ten.

- If any person or firm holds auditor ship of companies, whether singly or jointly, with any other person of firm, the number of such audits shall be counted to compute the specified number in the case of each such person or firm (Exp. 2).

Illustration. AB & Co. are appointed joint auditors of a company. Joint auditorship of this company shall be counted as one company audit in the case of each of the two firms. .

For comparing the specified number, audit of all companies, including non-profit companies and companies limited by guarantee, will be taken' into account.

Company audit excluded for computing "specified number"

For computing the specified number, the following audits shall not be counted:

- **Branch audit.** Where a person or firm is appointed as auditor of a company and also its branches, the branch audits will not be counted for determining the specified number. In any case, a branch auditor appointed under Sec. 228 cannot be put on par with the company auditor; and hence a branch audit is not to be counted as company audit (Circular No. 21 dated 24.9.1975 of the Department of Company Affairs, Government of India).
- Special audit, investigation, or audit of statutory corporation. These, are outside the scope of Sec. 224, and hence excluded from the specified number of 20 company audits.
- Audit of foreign companies being outside the 'Purview of Sec., 224, audit of foreign companies is not taken into account for computation of the specified number.
- Partner being in ful1- time employment elsewhere but holding certificate of public practice of' accountancy. Before the amendment to Sec. 224(1-B) effected by the Companies (Amendment) Act 1988, it was common for some firms to induct as partners those chartered accounts who are in full-time employment elsewhere, with a view to increasing the specified number of' audits in the case of the firm. However, with the amendment now, partners with full-time employment elsewhere will be excluded for counting the specified number of company audits in the case of the firm.

Illustration. A firm of auditors has three partners of whom one partner is in full time service of a company. The specified number in the case of the firm would be 40 company audits (i.e., 20 x 2) and up to 20 of these companies may have a paid-up share' capital of RS.25 lakhs or more.

4.6 REMUNERATION OF AUDITOR [SEC. 224(8)]

The remuneration of the auditor of a company may either be fixed by the company at its general meeting; or left to be fixed in any manner determined mil general meeting. In case the auditor is appointed by the Board of the Central Government, his remuneration may be fixed by the appointing authority.

The remuneration is inclusive of all expenses allowed to him and he is not entitled to any other payment, whether as expenses or otherwise. However, for legal or technical advice sought by him in connection with his duties as auditor he can claim the expenditure from the company. .

Similarly he may also be paid remuneration for services rendered in any other capacity, *e.g.,* as adviser in taxation matters, company law matters, management services, etc. But the Profit and Loss Account of the company' must contain *detailed information* as regards all amounts paid to him (Para 4-B, Part II of Schedule VI).

4.7 REMOVAL OF AUDITOR [SEC. 224 (7)]

First auditor(s)

The first auditor(s) of-a company appointed by the Board of directors prior to the first annual general meeting, may be removed by the members in general meeting. For this, it is immaterial whether or not the auditor (s) has completed his term of appointment. The general meeting may also appoint in his place' any other person nominated for the purpose by any member of the company. But notice of such nomination must be given at least 14 *days before the date of the general meeting.*

In other cases

Any auditor maybe removed from office before the expiry of his term. But this can be done only by the general meeting *after* obtaining *prior* approval of the Central Government in that behalf.

Sec. 225, which deals with resolutions for appointment and removal of auditors, provides safeguards against unfair and unjust removal of an auditor.

Safeguards against unfair and unjust removal

Under Sec. 224(2), reappointment of the retiring auditor, *except* in the specified cases, has virtually been made *automatic.* However, where it is proposed to remove the present auditor, whether by appointing someone else in his place or by resolving that he shall not be reappointed, the procedure as prescribed in Sec. 225 has to. be followed . The object of this is to safeguard the interests of an independent and conscientious auditor against unfair and unjust removal at the hands of an unscrupulous management:

The provisions of Sec. 225 are as follows:

- *Special notice of resolution.* For any resolution by a shareholder for the removal of the present auditor, a special notice of his intention to move such a resolution must be given to the company, at least 14 *days before the date of the general meeting.*
- *Retiring auditor to he informed.* On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.
- *Right to represent.* The retiring auditor has the right to make a representation in writing, not exceeding a reasonable length to the company with respect to the said resolution as communicated to him. He may also request the company to notify the representation to members of the company.

- *Company to comply.* -Where the auditor makes a representation to the company and requests its notification to the members, *and if the representation has not been received too late,* the company will be required - *(a)* to state in the notice of the resolution to the members that such representation has been made, and *(b)* to send a copy of the representation to every member to whom notice of the meeting is sent, whether *before or after* the receipt of the representation by the company.
- *Where representation is not notified.* In case a copy of the representation is not sent to the members .as aforesaid, either because it was received too late or because of default on the part of the company, the auditor may insist that the representation be *read out* at the general meeting. He may also make an oral statement at the meeting.
- *Right to attend meeting.* The auditor, *whom it is proposed to be removed,* can attend the general meeting at which his removal is to be discussed and decided upon. In fact, this is inherent in his right to make on oral statement at the meeting' as to his proposed removal.
- *Auditor not to abuse his right under Sec.* 225. The right to make an oral or written representation has been allowed to the auditor by way of safeguard against his improper removal. This is because the facts disclosed by him in such a representation may, in really bad cases lead to a detailed investigation into the affairs of the company concerned and the fear of such disclosure will deter a wily management from removing the auditor.

However, the right to make a representation and to have it sent out to members or read out at the meeting is hedged in by a proviso. It is that if, on an application by the company or any-other aggrieved person, the Company Law Board is satisfied, that the right is likely to be abused to secure needless publicity for a defamatory matter, it may order that the representation be not circulated to members or not read out at the meeting. The Company Law Board may also require the auditor to pay, wholly or in part, the company's costs on - such application to the Board even if the auditor is himself not a party to the said application.

- **Provision -to have wide application.** The above provisions are applicable to every resolution whether it relates to - (a) the removal of first auditors or any of them appointed by the directors under Sec. 224(5) before the - first annual general meeting; (b) the removal of any auditor(s} under Sec. 224(7), which permits the company to remove any auditor in its general meeting with the previous approval of the Central Government; or (c) appointment as auditor of a person other than the retiring auditor.

- **New auditor to communicate with outgoing auditor.** While a company is free to engage any personas' its auditor, the auditor should exercise care and caution before agreeing to work for a fellow-professional's client. Thus, where an auditor accepts a position previously held by another chartered accountant, he should first communicate with his predecessor in writing. Failure to do so would be tantamount to breach of professional etiquette and misconduct, falling within the acts or commissions specified under Sec. 22 of the Chartered Accountant Act, 1949: It may lead to an enquiry into his conduct by the Council of the Institute of Chartered Accountants and if his guilt is established, he may be declared unfit to continue as a member of the Institute.

Written communication between the new appointee and the outgoing auditor, who is also himself a member of the Institute, is emphasised for the sake of professional courtesy and to reduce occasions for friction between fellow members and promote cooperation 1:'etween them. A far more important purpose is that it affords the new appointee an opportunity to know the reasons why the outgoing auditor was not reappointed and, in the ,light of the information so obtained, to take suitable steps to protect the legitimate interests of the shareholders, other interested parties, as also his own,

With this end in view, the new appointee-should pointedly 'ask the outgoing auditor whether there is any professional reason why he should not agree to accept the appointment offered to him.

In fact, the Council of the Institute of Chartered Accountants is of the opinion that in every case where a chartered accountant is appointed to a position previously held by another chartered accountant, whether as auditor, liquidator, trustee or receiver, he should communicate with his predecessor in the interest of setting a healthy precedent.

4.8 STATUS OF AUDITOR

The status or position of an auditor may be discussed under the following three heads.

- As an agent of members.
- As an officer of the company.
- As an employee (servant) of the company
- As an agent of members

An agent is a person who is employed to do any act for another, or to represent another in dealings with third persons. The· question whether the auditor is an agent of the members, will thus have to be examined in the light of the duties expected of him.

The shareholders of a company have to depend on the good faith and efficiency of the auditor appointed to check the' accounts, and report on the Profit· and Loss Account, and Balance Sheet of the company. This makes the auditor responsible for safeguarding the rights of the shareholders *vs-a-vis* the activities of directors in exercise of their powers

dealing with the assets of the company. He may commit errors of judgement and yet not invite any liability because it is nobody's case that he is infallible and will never go wrong. But he will be liable if he does not perform his duty properly, or if he is guilty of gross negligence or fraud.

In *Royal British Bank* case, the auditors, like directors, were held to be agents of the shareholders. In *Spackman* v. *Evans* (1868), it was observed that while the auditor is an agent of the shareholders, the shareholders on their part are not necessarily bound by everything of which notice is given to the auditor.

Thus, an agent-principal relationship between, the auditor and the shareholders is clearly established. But the auditor is *not* an agent of the company. in every case and his certificate on the Balance Sheet is *not* an acknowledgement of the indebtedness of the company [In re Tran planters (Holding Co.) Ltd]

4.9 RIGHTS OF COMPANY AUDITORS

Right of access to books, accounts and vouchers [Sec. 227(1)]

The auditor has the right of access, at all times, to the books arid accounts and vouchers of the company, whether kept at the head office of the company or elsewhere. The right of access to books, etc., is an *absolute* right and it is not subject to any restriction, exception or qualification.

The term "books" includes not only the financial books of the company but also statutory and statistical books. Thus, cost records which are required to be maintained by certain companies under Sec. 209 (1)(*d)* are covered under the term. The term "vouchers" includes all documents, correspondence, agreements, etc., containing evidence as to any of the transactions or data disclosed in the financial statements, whether directly or indirectly. The right of access "at all times” refers to the period during which me auditor works as auditor of the company. It also means that the auditor can undertake examination of the books, etc., at any time during the normal working hours, and need not wait till the accounts are closed.

Rights to obtain information and explanations [Sec. 227(1)]

The auditor has the right to obtain from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor.

It is for the auditor to determine what information and explanations will be necessary to enable him to perform his duties as auditor. Even if any information is not available from the accounts of the company, the officers are under an obligation to provide it. If any information or explanation is refused on the ground that it is not necessary for the performance of his duties, the auditor is entitled to report accordingly to the members.

Rights to receive notice and to attend general meeting [Sec.231]

The auditor has the right to receive all notices and other communications relating to any general meeting of the company in the same way in which any member of the company is entitled to receive them. He has also a right to attend any general meeting and to be heard thereat in respect of any part of the business which concerns him as auditor. But making a statement at a general meeting will not absolve him of his obligation to make the statement thereat, under Sec.227.

The right to attend a general meeting and to speak thereat is *permissive,* and *not* mandatory. In other words, the auditor is not duty-bound to attend or to take part in the discussion at the meeting. Such right is restricted to general meetings alone and does not extend to meetings of the Board. But while there is no binding to exercise this right, the auditor has a duty to attend and take part in the proceedings at the meeting *if* he has reason to believe that the directors are likely to deliberately present a false picture of the state of affairs of the business, or that they are likely to distort the meaning of any remarks made by him in the audit report. He should also exercise this right when any information having material bearing on the financial statements has come into his possession after the signing of the report and which, if it had come to his notice earlier would have resulted in his making a different report. But it should be remembered that any statement by him in the meeting to this effect will not absolve him of the responsibility for any omission or incompleteness in the report.

Right to report to members [Sec. 227(2)]

The auditor has the right as well as duty. to make a report to the members on the accounts examined by him, and to state whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Companies Act in the manner as required, and whether the financial statements give a true and fair picture of the state of affairs of the business of the company and as to the results of its operations.

Right to sign audit report, etc. [Sec. 229]

Only the person appointed as auditor of the company can sign the auditor's report, or sign or authenticate any other document of the company which the law requires to be signed or authenticated by the auditor. In case the auditor is a firm, only a partner of the firm practising in India, can do so.

Right to visit branches [Sec. 228(2)]

In case the accounts of any branch, office are audited by a person other than the company's auditor, the company auditor- . .

(a) shall De entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor; and

(b) shall have the right of access at all times to the books and accounts and vouchers of the company as maintained at the branch office

However, in the case of a banking company having a branch office outside India it would be sufficient if the auditor is allowed access to such copies of, and extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company in India.

Right to have legal and technical advice

Where the auditor needs expert advice in respect of any legal or technical matter for the proper discharge of his duties he may seek it at the expense of the company, the payment for which will be a permissible extra expenditure for the company.

Right to receive remuneration [Sec. 224(8)]

The auditor has the right to receive remuneration for auditing the accounts of the company though 'such right accrues only after he has completed the work. In *Herbert Alfred Burleigh* v *Ingram Clerk Ltd.* (1990), it was held that the auditor could exercise lien on certain books for his remuneration, though this decision is *not* applicable to India.

4.10 DUTIES OF COMPANY AUDITORS

Duties of a company auditor may broadly be discussed under the following two heads:

- Statutory duties.
- Duties under Common Law.

4.10.1 STATUTORY DUTIES

Report to members [Sec.227(2)]

The auditor is required to make a *report to the members* of the company:

- on the *accounts* examined by him;
- on the *Balance Sheet* and the *Profit and Loss Account.* and

on *every other document* declared by the Companies Act to be *part* of, or *annexed to* the Balance Sheet or Profit and Loss Account, which are laid before the company in general meeting during his tenure of office. Further, his report must state whether *in his opinion* and *to the best of his information* and *according to the explanations given to him,* the said accounts give the information *required* by this Act *in the manner* so *required* and give a *true and fair view-:-*

(a) in the case of the Balance Sheet, of the *state of company's affairs* as at the end of the' financial year; and

(b) in the case of the Profit and Loss Account, of the *profit or loss* for its financial year.

- ***Report to members***. According to *Company's Precedents* by Palmer, "report to the members" does *not* mean that the auditor should send his report to all the members. As a rule, the auditor sends his report to the secretary to be laid by him before the company in general meeting. But in view of the fact that the report is required to be read before the company in general meeting (Sec. 230), and also that the auditor has the right to attend such meeting and speak thereat on matters concerning him as auditor (Sec. 231), it may be inferred that it is also his duty to see that the report reaches the members in the meeting.
- ***Examination of accounts***. The auditor has to stale in his report whether, in his opinion, proper books of account *as required by law* have been kept by the company. "As required by law" would include the requirements of Sec. 209(3). *i.e.* that the books should be so kept as to give a true and fair view of the state of affairs of the company and explain its transactions. This obviously is an exacting duty as regards verification, because it requires the auditor to satisfy himself by examining such basic materials and documents as he considers necessary, such that the accounts examined by him reflect a true and fair view of the state of affairs of the company concerned.
- ***Annexed documents***. The auditor's report has to deal with not only the accounts and Balance Sheet and Profit and Loss Account but also every other document which is declared by the Act to be part of, ,or annexed to, the Balance Sheet and Profit and Loss Account:
- ***True and fair view***. The primary duty of the auditor, is to express his opinion whether the Balance Sheet shows a true and fair view of the state of the company's affairs as at the end of the financial year, and whether the Profit and Loss Account shows a true and fair view of the results of operations of the company for that year.

The phrase "true and fair" has not been defined under the Act. The only requirement as per Sec. 211 is that every Balance Sheet and every Profit and Loss Account of a company shall give a true and fair view' of the state of affairs and the profit or loss of the company and shall comply with the requirements of Parts I and II of Schedule VI so far as they are applicable. A combined reading of Sec. 211 (3) and (5) will indicate that Balance Sheet and Profit and Loss Account will be deemed as showing a true and fair view when they comply with the requirements of Schedule VI, unless these have been waived or modified as specified.

However, drawing up of financial statements according to the disclosure requirements of Schedule VI alone will not make them truly and fairly representative of the· state of affairs of profit/loss. of the business. This is because Schedule VI only refers to the minimum disclosure requirements. In other words, if certain information has a material

bearing on the representations made in the financial statements, it must be disclosed even if there is no specific legal requirement for its disclosure W1der Schedule VI.

The requirements of truth and fairness in the representations in financial statements extend far beyond ensuring mere arithmetical accuracy or seeing that they correspond to the figures in the books of account of the company. To quote Halsbury's Laws of England, "it is the duty of an auditor to verify not merely the arithmetical accuracy, to see that it includes the particulars required by the Articles and by Statute, and contains a correct representation of the state of the company's affairs. To do this, he must examine the books and take reasonable care to see that their contents are substantially accurate ... he must ask for information on matters which call for further information."

In a nutshell, before expressing his opinion on the truth and fairness of the financial statements, the auditor must see:

- that they are drawn up according to exact legal requirements;
- that they show the financial position and profit/loss without any distortion;
- that they do not contain any mis-statement as to incomes or expenses;
- that the generally accepted principles of accounting have consistently been followed in drawing up the financial statements; and
- that all necessary information is made available to the shareholders as to the true financial position of the company.

According to Halsbury's Laws of England, the auditor must give the information and not merely indicate the means of acquiring it. "... *So* an auditor who reports confidentially to the directors the insufficiency of the securities on which capital is, invested and the difficulty of realization, but whom only reports to the shareholders that the value depends on tea1isation, with the result that the shareholders ignorantly approve an improper dividend, is liable to make good the amount paid. "

Duty as to inquiry:

Sec. 227 (I-A) specifies six matters which are required to be enquired into by the

company auditor'. These are:

- ***Loans and advances***. He has to see whether loans and advances made by the company on the basis of security have been properly secured, and whether the terms on which they have been made are *not prejudicial to the interests of the company or its members.*
- ***Transactions represented merely by book entries***. He must see that transactions which are not supported by any facts or evidence, though recorded in the books, are *not prejudicial to the interests of the company.*

- ***Sale of investments at less than purchase price***. Where the company is *not* an investment company or a banking company, the auditor is required to see whether it has sold any shares, debentures or other securities any price which is *lower* than their price purchase.
- *Loans* ***and advances show as deposits***. He has to see whether loans and advances made by the company have *not* been shown as deposits, so as to avoid scrutiny by the members or others.
- ***Personal expenses***. He should enquire whether any personal expenses have been charged to revenue accounts of the company, so as to *improperly* utilise the funds of the company for the individual benefit of any person directly or indirectly in control of th.:3 affairs; of the company.
- ***Allotment of shares for cash***. Where it IS stated in the books and papers of the company that any shares have been allotted for cash, the auditor must enquire whether cash has *actually* been received in respect of such allotment, and if no· cash has actually been received, whether the position as stated in the account books and the Balance Sheet is correct and regular.

According to the Research Committee of the Institute of Chartered Accountants of India, "The auditor is not required to report on the matters specified in Sec. 227(1-A) unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the inquiries, he has no further duty to report that he is so satisfied. In such a case, the contents of the Auditor's Report will remain exactly the same as hitherto. The auditor has to inquire and apply his mind to the information elicited by the enquiry, in deciding whether or not any reference needs to be made in his report. In our ·opinion, it is in this light that the auditor has to consider his duties under Sec. 227(l-A)".

Report as to additional matters [Sec. 227(4'-A)]

Under Sec. 227(4-A), the Central Government has power to direct, by means of a general or special order, that in the case of companies specified in such order, the auditor's report shall also include a statement on such matters as may be specified therein.

- In exercise of this power, the Central Government has issued the Manufacturing and Other Companies (Auditor's Report) Order (MAOCARO), 1988, superseding the Order of 1975, which has become effective from 1st November, 1988.

The Order will apply in the case of every company which is engaged or proposes to engage in one or more of the following activities:

(a) manufacturing, mining or processing ;

(b) supplying and rendering services;

(c) trading; and

(d) the business of financing ; investment; chit fund, midhi or mutual benefit societies.

(For detailed discussions of the MAOCARO 1988. see chapter 16, Audit Report.)

Duty to sign report (Sec. 229)

It is the duty, as well as right of the auditor to sign the report prepared by him. In case the auditor is a firm; only a partner of the firm practising in India, may sign the report.

Duty as to statutory report [Sec165(4)]

After the statutory report has been certified as correct by the required number of directors, the auditor of the company 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 payments of the company

Duty as to prospectus [Sec.56(1)]

The format of the prospectus as given in Schedule II to the Companies Act has been revised effective from 1st November 1991. According to the revised Part II of Schedule II, the prospectus of the company will include a report by the auditor as regards the following;

(a) profits and losses, and assets and liabilities in accordance with whether the company does, or does' not have subsidiaries;

(b) the rate of dividend paid by the company in respect of each class of shares in the company for each of the *five financial years* preceding the issue of the prospectus;

(c) if any proceeds of the issue of the shares or debentures are to be applied in the purchase of any business or in the purchase of any interest in any business exceeding *fifty per cent* by way of capital or profits, the report will indicate the profit or losses of the business for each of the *five financial years* preceding the issue of prospectus and assets and liabilities of the business at the last date of making up the accounts;

(d) if any proceeds of the issue of the shares or debentures is to be applied by the company to acquire shares in any other body corporate which has the effect of making that body corporate a *subsidiary* of the company, then the report will indicate the profits or losses of the *other* body corporate for each of the *five fi1Wncial years* preceding the issue of the prospectus and the assets and liabilities of such body corporate at the last date of making up of the accounts;

(e) the manner how the profits or losses of the *other* body corporate would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have to be made in relation to the assets and liabi1ities for holders of other shares, if the company had held the shares to be acquired; and.

(f) if the *other* body corporate has subsidiaries, then the report will deal with the profits or losses and assets and liabilities of the body corporate and its subsidiaries in the prescribed manner.

Duty as to report under voluntary winding up [Sec. 488(2)]

Where a company has been wound up voluntarily, and the required number of its directors has made a declaration as to its solvency, the declaration will not have effect *unless* it is accompanied by a report of the auditor as to the Profit and Loss Account and the Balance Sheet. Thus, the auditor is under a duty to prepare such report, as· far as circumstances admit, in accordance with the provisions of the Companies Act.

Duty to assist investigation [Sec. 240]

Where an inspector is appointed under Sec. 235 or 237 to investigate the affairs of the company, it is the duty of the auditor [who is regarded as an *agent·* of the company for this purpose as per Sec. 240(6)(b)]

(a) to preserve and to produce to the inspector, all books and papers of, or relating to, the company (or any other body corporate) which are in his custody or power; and

(b) otherwise to give to the inspector all assistance in connection with the investigation which he is reasonably able to give.

Statutory duties not to be curtailed:

The duties of an auditor, as prescribed by law, cannot in any way be curtailed either by the Articles, or by the directors or members, though a company is always free to enlarge the scope of his duties by passing a re solution at the general meeting, or making a provisions in its Articles.

4.10.2 DUTIES UNDER COMPANY LAW

Duty to perform contract

The auditor is under a duty to the party who has appointed him, and this duty is discharged when he has performed the terms of the contract between him· and that party. As already seen, the scope of statutory duties of a company auditor cannot in any way be curtailed. But where it has been enlarged by passing a resolution at the general meeting, or making a provision in the Articles, the auditor has a duty to perform the additional work.

Duty of care and caution

The auditor holds himself out as an expert and must act honestly and exercise due care and caution in the performance of his engagement. As an expert he cannot set up ignorance as a defense. He must prove that ill the course of his audit he has employed skills that word reasonably be applied by any other auditor.

As observed in *Cooley on Torts* (4th. Edition, Vol. 3)

"Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses, with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment and, if his pretensions are unfounded, he commits a specie of fraud upon everyman who employs him in reliance on his public profession.

"But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without any fault or error. He undertakes for good faith and integrity but not for infallibility and while he is liable to his employer for negligence; bad faith or dishonesty there will be no liability for loss consequent upon mere error of judgment."

To sum *up,* so long as the auditor acts honestly and without negligence, and adheres to the generally accepted auditing standards, and follows the generally accepted auditing procedures, he cannot be held liable for any fraud, defalcation or irregularity which, inspite of adherence to such standards and procedures, he has not been able 10 discover.

- ***London & General Bank case* (1895).** For several years, the auditors kept on pointing out to the *directors* the unsatisfactory nature of the securities against which a substantial part of the-capital was advanced as loans. However in their report to the member they only said that "the value of the assets as shown in the Balance Sheet is dependent on realization." On the faith of this, dividends were paid by the company even though there was no profit. The auditors were held liable for failure to ascertain the true financial position of the company and to report to shareholders. But it was observed in the judgement that, "An auditor is not bound to do more than exercise reasonable care and skill in making enquiries and investigations: Where there is nothing to excite suspicion, very little enquiry will be reasonably sufficient. Where suspicion is aroused, more care is obviously necessary. But he (auditor) is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs".
- ***Kingston Cotton Mills case* (1896).** The auditor accepted the valuation of stocks as done by the manager. The value was grossly overstated. This led to payment of dividends out of capital the auditors did not examine the books, and if they had done so, they would have definitely come across material warranting explanation as to valuation of stock. The Court acquitted .the auditors and held: "The auditor is a watch-dog, but *not* a blood-hound. If there is anything calculated to excite suspicion, he-should probe it to the bottom; but' in the absence of anything of that kind, he is only bound to be reasonably cautious and careful."

- ***City Equitable Fire Insurance Co. case (l925).*** Apart from statutory duties of an auditor, which cannot be curtailed either by Articles or an agreement, the exact duties of an auditor are regulated by the contract under which he is appointed. Again, the statutory duties are not absolute but depend on the explanations furnished and information given. As to inspection of· securities, the Court observed: "That it is the duty of a company auditor in general to satisfy himself that the securities of the company do in fact exist and are in custody, cannot be denied." But if the securities are in safe custody of a banker in the ordinary course of business, he may rely upon the certificate of the banker.
- ***Allen Craig & Co. case* (1934).** After having signed the report to be annexed to .the Balance Sheet the auditor's duty consists only in forwarding that report to the secretary of the company. Thereafter, it is for the secretary and directors of the company to convene the general meeting and send the Balance Sheet and the report to ~e members and other persons entitled to receive the same".

4.11 JOINT AUDITORS

In certain cases, either due to extensive business operations such as in the case of banking and insurance companies, or because of other requirements or regulations, a company (or any organisation) may appoint more than one person to act as its auditors.

The "Statement on the Responsibility of Joint Auditors" issued by the, Institute of Chartered Accountants of India describes the professional responsibilities of the members undertaking joint audit work. The main points of the Statement may be summarised as follows:

- If the division of work between the joint auditors is such that a specific part of audit work in relation to a particular area is done by each auditor alone, each joint auditor will be responsible only for the work allocated to him.
- Division of work between joint auditors should be by mutual discussion and the client should be informed as to their respective areas of work. If a natural division of audit work is not possible, the work should be divided based on classification of assets and liabilities and/or income and expenditure over periods of time.
- Matters requiring discussion, disclosure or application of judgment should be brought to the attention of the other joint auditors before finalization of the audit.
- Each joint auditor has a separate and specific responsibility to evaluate and review the existing system of internal control and determine the audit tests and depth of review.
- If audit of different branches or divisions has been entrusted to different joint auditors, each joint auditor will have specific and separate responsibility to review the returns of the respective branches and divisions.

- It is not incumbent on any joint auditor t~ review the work done by' other joint auditors, and he is entitled to presume that they have carried out their respective parts of the work according to the normal standards laid down by the Institute and the generally accepted auditing standards.
- If the joint auditors are not in' agreement in respect of the report, each of them may make a separate report. There is no question of majority or minority opinion in the case of a joint audit report,' and each joint auditor has both a right and a duty to express his own opinion.

4.12 BRANCH AUDITORS

Audit of a branch of a company is to be carried out by the statutory auditor or by any other auditor who is qualified to act as such. The auditor for a branch may be appointed by the company in its general meeting, or by the Board of directors, in consultation with the statutory auditor. However, in either case the statutory, auditor will not be responsible for the work done by' the branch auditors.

Branch auditors are under an implied obligation to perform their work in a manner that the returns, *i.e.,* Balance Sheet, Profit and Loss Account, etc. sent by them to the head office are meant to be incorporated in the final statements of the head office, to enable the statutory auditor to comply with the legal, requirement as to disclosure.

Considering the materiality of branch accounts, the statutory auditor can communicate with, and make necessary enquiries from the branch auditors in the interest of overall audit objectives. He can also require the branch auditor to answer any written communication sent by him as regards branch audit.

The statutory auditor has a right in certain cases to Visit any branch office to examine its books of account and vouchers, but he is not duty-bound to do so and may rely on the work of branch auditors.

4.13 SHARE CAPITAL

Share capital may be defined as the capital rose by a company by the issue of shares. The term ‘share capital’ is used in several senses. Thus, it may mean nominal, issued and subscribed, uncalled and paid up capital.

- **Nominal, authorized or registered share capital:** It means the maximum capital which a company is authorized to issue by memorandum of Association, unless it is increased in the manner as prescribed.
- **Issue and subscribed share capital:** It represents the nominal value of the shares of the company actually allotted and includes both – shares issued for cash, shares issued for consideration other than cash.

- **Uncalled capital:** It is the portion of the nominal value of shares actually issued, which has not yet been called up.
- **Paid up capital:** It means that amount of money that has been paid or deemed to have been paid on shares actually allotted.

4.13.1 Kinds of Share Capital

Secs. 85 to 89 of the Company's Act lay down provisions relating to the kinds of share capital of a company. These are not applicable to a private company unless it is a subsidiary of a public company.

According to sec. 86, the share capital of a company shall be of two kinds namely –

a. Preference share capital; and

b. Equity share capital

a) Preference Share Capital: [Sec. 85(1)]. In the case of a company limited by shares, Preference Share capital means that part of the capital of the company, which fulfills the following requirements:

1. It cares the preferential rights as to payment of dividend, which may be either a fixed amount or an amount calculated at a fixed rate; and
2. it caries on winding up or repayment of capital, a preferential right to be repaid the amount of the capital paid up or deemed to have been paid up.

Thus, there are two important characteristics of preference share capital, namely-

a) preferential right to payment of fixed dividend; and

b) Preferential right to repayment of capital in the event of winding up, or any other arrangement. In addition it may or may not have the following rights, viz. i) a preferential right to be paid any arrears of dividend remaining due on such shares; ii) a right to be paid a fixed premium; iii) a right to participate in surplus profits by way of additional dividend: and iv) a right to share in the surplus assets in the event of winding up, after all kinds of capital has been repaid.

b) Equity Share Capital: [Sec.85 (2)]. It means share capital which is not preference share capital. A private company, which is not a subsidiary of a public company, may create and issue other kinds of share capital and on any terms, as it may think fit.

4.13.2 Audit of Issue of Share Capital

- **Audit objectives:** The principal objectives of audit of share capital are as follows:

o that various issues of shares are properly authorized and that there is no over-issue beyond the limits as prescribed in the Memorandum;

- the cash and other assets acquired through the issue of shares have indeed been received, properly classified, valued and correctly recorded in the books of account;
- that distribution of dividend and retention of profits in the form of reserves and provisions are properly authorized;
- that t relating to rights and privileges of share holders, creditors etc., are duly complied with; and
- the generally accepted accounting principles are followed in stating the account balances and these are disclosed in the Balance Sheet in conformity with legal provisions.

Issue of Shares

Almost every company limited by shares has to raise share capital after its incorporation. Even subsequently, it may raise capital for new or ongoing activities, either by adding to its issued capital, or by increasing the nominal capital by altering the memorandum in the prescribed manner.

- **Prospectus:** Issue of prospectus or a statement in lieu of prospectus must precede the raising of capital by a public company, though it is not necessary in the case of a private company. According to the amended Sec. 73, public issues have to be compulsorily listed with recognized stock exchanges. If a company does not apply for it or if its application is not granted with 10 weeks, it will have to repay the entire money received from share applicants, within 8 days after it has become liable to do so.
- **Memorandum of Association:** The auditor should examine the capital clause in the memorandum to ascertain (a) the nominal or authorized capital; (b) the number of shares authorized with respect to each clause of shares; (c) nominal value of each class of shares. (d) rate of dividend for preference shares, including their features, e.g., cumulative, participating and redeemable; (e) voting power (or the lack of it) for each class of shares; and (f) other matters of importance with respect to audit of share capital.
- **Articles of Association:** The author should examine these for the purpose of ascertaining the procedure relating to – (a) issue of share capital; (b) calls on shares (c) calls in advance or arrear (d) forfeiture and reissue of forfeited shares (e) Transfer and transmission of shares (f) payment of commission on shares; and (g) rights of various classes of share holders.

Audit procedure:

- **Preliminary:** The auditor should study the conditions relating to issue of share capital in the Memorandum and Articles of Association, as well as prospectus or statement in lieu of prospectus, and see that these have been duly complied with.

- **Minimum amount payable on application:** He should see that the amount payable on each application is not less than 5% of the nominal amount of the share [Sec.69(3)].
- **In the case of the first allotment:** The auditor should see that the first allotment of shares conforms to the guidelines issued by the Securities and the Exchange Board of India (SEBI) as regard pricing shares. Accordingly, a new company which has not completed twelve months of commercial operations, who's audited operated results is not available, and which has been set up by entrepreneurs without a track record, the issue of capital to the public can only be at par.
- **In the case of fresh issue by existing listed company:** Such a company is permitted to raise fresh capital by freely pricing its issue. But the auditor should see that-(a) the issue price has been determined by the issuer in consultation with the lead managers to the issue. (b) draft prospectus of the company is expertly appraised by the SEBI; (c) there is due disclosure of the net asset value of the company and justification of the price of the issue; these are as provided in the SEBI guidelines will also have to be complied with.
- **Cautionary note on prospectus:** (Sec. 68A). He should see that the following cautionary note is prominently reproduced on the prospectus: 'Any person who –
  - Makes in fictitious name an application to a company for acquiring or for subscribing for any shares therein; or
  - Otherwise induces a company to allot, or register any transfer of shares therein to him, or any other person in fictitious name, shall be punishable with imprisonment for a term which may extend to five years.'
- **Preliminary contracts:** He should see that all preliminary contracts for the purchase of the property or business have been performed in accordance with the terms stipulated in the Prospectus.
- **Some procedure stages:**

There are some procedure stages which hold some rules:

- Audit procedure at application stage
- Audit procedure at allotment stage
- Audit procedure at calls stage
- Other general duties.

Shares issued for consideration other than cash:

Shares may also be issued for consideration other than cash. This will happen when fully or partly paid shares are issued in consideration of any property proposed to be sold, or services to be rendered to the company. Issue of shares in consideration of release of a claim, or by way of compromise, will also fall in this category. The audit procedure in regard to issue of shares in such a case should be as follows:

- **Examination of contracts:**The auditor should examine the contract under which shares have been allotted for consideration other than cash. In the case of purchase of property or business, the contract will show the amount of purchase consideration. In case of shares have been issued as remuneration to underwriters for services rendered by them, the author should ascertain the terms and conditions of payment from the contract with them. Where shares have been issued to promoters the contract with them should be examined to ascertain the nature of consideration.
- **Examination of prospectus:** He should examine the prospectus for details as to the amount payable to vendors, underwriters and promoters and the mode of payment.
- **Director's minute book:** The resolutions passed by the directors for allotment of shares to vendors, underwriters or promoters should be confirmed from the minute book.
- **Journal entry:** He should check the journal entry concerning the issue of shares for consideration other than cash, and see that it is in order.
- **Complaints with legal provisions:** Under sec 75(1)(b), of the companies act, if shares are allotted for consideration other than cash, the original contract together with the copy thereof, duly verified by an affidavit, should give the number and nominal amount of shares allotted, the extent to which these will be treated as paid up and the consideration for which these have been issued. The documents should be filed within 30 days of the days of allotment of the shares. The auditors should ensure that these provisions have been duly complied with.

Issues of shares at a premium: According to section 78, were a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares will be transferred to an account., to be called share premium account.

- **Auditors duty:** According to the guidelines issued by SEBI, freedom to price the issue is allowed in the case of (a) a new company which has seen set up by existing companies with a 5-year track record of consistent profitability; (b) first issue by an existing private or closely held company which has a 3-year track record of consistent profitability and (c) fresh issue by an existing listed company. Accordingly, the auditor should examine the Articles and the minutes of the Board meetings to ascertain whether issue of shares at a premium is duly authorized. He should also verify whether the announcement in the prospectus is in conformity with these requirements.
- He should see that the amount of share premium is utilized in the manner laid down in sec. 78. As held in the case of Duff's Settlement Trusts (1951), the effect of this provision is to create a new class of capital which is not share capital but which, at same time which not distributable among the share holders except in the case of winding up or, in any other case, through the medium of reduction of share capital upon going through all the necessary formalities for the purpose.

Issue of shares at a discount (Sec.79)

A company cannot issue shares at a discount except as provided in Sec. 79(1). The conditions laid down for this are as follows:

- o The issue should be authorized by an ordinary resolution of the company and sanctioned by the Company Law Board.
- o The resolution should specify the maximum rate of discount at which shares are to be issued. In any case, the rate cannot exceed 10% unless the Company Law Board is of opinion that a higher percentage may be allowed in the special circumstances of the case.
- o The shares to be issued at a discount should be of a class already issued by the company.
- o The company should be working for at least one year from the date it was entitled to commence business before it can issue shares at a discount.
- o The shares to be issued at a discount should be issued with in two months after the date on which the issue is sanctioned by the company law board.

Auditor's duty: He should see that the provisions of Sec.79 have been duly complied with. Where the issue of shares is not in conformity with the provisions of this Section, the directors who have authorized such issue and the allot tees, who have accepted the allotment and whose names have been entered in the register of members, shall be liable to the company for the full amount of shares.

- He should see that the Prospectus relating to the issue of shares contains particulars as to the discount allowed on the issue, or the amount of discount not written off at the date of prospectus.
- He should see that the amount of discount, not yet written off, is shown separately in the Balance Sheet under the head "miscellaneous expenditure".

Issue of Share Certificates

According to Sec. 113, every company must deliver the share certificate with in three months after the allotment of any of its shares or with in two months after the application for registration of the transfer of any such shares. The same provisions are applicable in respect of issue of certificates as regards debentures and debenture stock. However, the above time-schedule for delivery of share certificates on allotment of any shares, or on application of registration of the transfer of any shares, is not required to be observed if the company has been prohibited to do so by any provision of law or order of any court, tribunal, or any other authority.

Further, in the case of deli very of certificates of debentures or debenture stock, the Company Law Board may, on application by the company, extend the period as prescribed.

Issue of share certificates is governed by the Companies (Issue of Share Certificates) Rules 1960, as framed by the Central Government. Accordingly, a share certificate can be issued only in pursuance of a resolution of the Board of directors and on surrender to the company of the letter of allotment, or of fractional coupons of requisite value, *except* in the case of issues against letters of acceptance or renunciation, or in the case of issue of bonus shares.

Particulars of every share certificate are required to be entered in the Register of Members or, as the case may be, Register of Renewed or Duplicate Certificates, and all entries in both the registers should be authenticated by the secretary or any other duly authorised person.

Auditor's duty. The auditor must, ascertain whether all provisions of Sec. 113 as also the Companies (Issue of Share Certificates) Rules have been dilly complied with.

The entries in the Register of Members should be verified with the counterfoils of the share certificates.

It should be seen whether all the books and documents concerning the issue of share certificates are properly maintained and preserved and certificates surrendered to the company are dilly defaced by the word “cancelled".

Issue of share warrants

According to Sec. 114, a *public company limited by shares* may convert its fully-paid up shares into share warrants if the following conditions are satisfied:

(a) The shares are fully paid up.

(b) The Articles authorize the issue of share warrants.

(c) Prior approval of the Central Government has been obtained.

(d) The share warrants are issued under the common seal of the company.

A share warrant entitles the bearer to the shares specified therein, and it may be transferred merely by delivery of possess-ion. The company may provide for payment of the future dividends on the share warrants, by attaching coupons for the dividend with the warrant itself. Dividend is then payable to the bearer of the coupon.

According to Sec. 115, on the issue of a share warrant, the company will strike out of the Register of Members the name of the member in respect of the shares specified in the share warrant as if he had ceased to be a member, and will enter in that Register - *(a)* the fact of issue of the warrant; *(b)* a statement of, the shares specified in the warrant, distinguishing each share by its number; and *(c)* the date of the issue of the warrant.

Auditor's duty:

- The auditor should examine the Articles to see whether the issue of share warrants is duly authorised therein.
- He should see whether requisite approval of the Central Government has been secured and the provisions of Sec. 114 and 115 have been duly complied with.

- He should ascertain whether the names of shareholders, to whom Share warrants have been issued, have been deleted from the Register of Members and entered instead in the Register of Share Warrants.

4.14 AUDIT OF CALLS ON SHARES

Calls in arrear:

They represent sums due from the shareholders in respect of calls made by the company as to the outstanding amount on shares or a portion thereof. Often, the Articles of the company provide for a charge of interest on calls in arrear.

Auditor's duty: He should verify the amount of calls in arrear from the Share Register.

- It should be seen that the amount of calls in arrear is properly shown on the liabilities side of the Balance Sheet by deducting it from the amount of called-up capital.
- The amount of calls due from directors should be separately shown in the Balance Sheet

Calls in advance

Under Sec. 92, a company may, if so authorised by its Articles of Association, accept from any member the whole or a part of the amount remaining unpaid on any shares held by him, although no part of that amount has yet been called up. However, the amount so received cannot be treated as part of the capital for purposes of any voting rights. But according to Sec. 93, a company may, if so authorised by its Articles, pay dividend in proportion to the amount paid up on each share where a larger amount is paid up on some shares than on others.

Where the company does not exercise its right under Sec. 93, the shareholders who have paid calls in advance shall be entitled to receive interest at the rate prescribed in the Articles of Association. Such interest is chargeable against profits but in case profits are not available for the purpose, it can be paid out of capital. Similarly, in the case of winding up, repayment of calls in advance along with interest accrued thereon, will take precedence over return of capital.

Auditor's duty. • He should see that calls in advance are shown separately in the Balance Sheet, and not shown as part of capital.

- It should be noted that Clause 88(2) of Table 'A' provides that calls in. advance should not be treated as amounts paid on shares for the purpose of payment of dividend, l1ms, if the Articles do not permit payment of dividend in the case of calls in advance, the· auditor should see that the shareholders concerned are paid interest it at the rate specified in the Articles.
- The amount of calls in advance should be checked, with entries in the Share Register and the Cash Book.

4.14.1 Audit of Redemption of Preference Shares

Under Sec. 80, a company limited by shares may, subject to authorisation by its Articles, issue preference shares which are (or at the option of the company) liable to be redeemed. According to See.80A, introduced by the Companies (Amendment) Act 1988, all existing preference shares which are irredeemable, or redeemable not before 10 years, have compulsorily to be redeemed (in the case of irredeemable shares within *five years* from commencement of the Amending Act, and in the case of shares which are not redeemable before the expiry of ten years, on the date of redemption, or within 10 years from the commencement of the 1988 Act), and now the companies can only issue preference shares which are redeemable in 10 years. Such redemption may be on or before an appointed date. Where no date of redemption has been fixed, the period of notice required for redeeming the shares and the method of redemption is specified in the prospectus.

Redemption of, preference share so will be subject to the following conditions:

(*a)* Only *fully-paid* preference shares can be redeemed.

(b) The shares can be redeemed only out of *profits* available for distribution as dividend, or out of proceeds of *afresh issue* of shares made for the purpose of such redemption. .

(c) The premium, if any, payable on redemption should be provided for either out of the Share Premium Account or the divisible profits of the Company.

(d) In case shares are redeemed out of profits which would otherwise be available for dividend, an amount equal to the normal amount of the shares redeemed should be transferred to the credit of the Capital Redemption Reserve Account.

Auditor's duty. • He should see that issue of redeemable preference shares is properly authorised by the Articles.

- He should see that so long as the shares are not redeemed, the terms of redemption (or conversion), if any, are stated in the Balance Sheet together with the earliest date of redemption (or conversion).
- He should see that redemption of shares is in accordance with the provisions of Sec. 80 and the new Sec. 80A.
- In case redemption is from out of profits which would otherwise be available for distribution of dividend, he should see that the normal value of the shares redeemed has been transferred to the Capital Redemption Reserve Account. This account should be treated as part of capital of the company in the same way as Share Premium Account
- In case shares have been redeemed out of a fresh issue, he should verify the Articles and the Minutes of the meetings of the Board.

4.14.2 Audit of Alteration of Share Capital

Under Sec. 94, a limited company having a share capital may if so authorised by its Articles, *alter* its share capital, that is to say it may-

(a) *increase* its share capital by issuing new shares;

(b) *consolidate and divide* allot any part of its share capital into shares of *larger* amount;

(c) *convert* fully paid shares into stock, or *vice~versa;*

(d) *sub-divide* its shares, or any of them, into shares of smaller amount ;

(e) *cancel* shares which have not been taken up, and diminish the amount of its share capital by the amount of shares so cancelled.

For alteration of share capital in any of the ways described above, the company need only pass an ordinary resolution and it is not necessary to obtain confirmation from the Court. However, a notice of such alteration should be given to the Registrar within 30 days thereof.

Auditor's duty. • He should see that the alteration is duly authorised by the Articles of Association. .

- He should study the minutes of the shareholders' meeting and see that a resolution authorising the alteration has been duly passed.
- He should study the minutes of the meetings of the Board and see that the resolution as to alteration, in pursuance of the resolution. of the members, has been duly passed. • He should examine the Allotment Lists giving- particulars of the old and new holdings of shares or stock in the case of each member, and compare the same with the entries in the Register of Members and in the relevant books of account
- He should inspect the cancelled share certificates, if any: and compare these with counterfoils of the new share certificates issued.
- He should see that the share capital as altered is correctly disclosed in the Balance Sheet.

4.14.3 Audit of Reduction of Share Capital

According to Sec. 100, a company limited by shares, or a company limited by guarantee but having capital may, if so authorised by its Articles and after passing a special resolution, and obtaining confirmation from the Court in certain cases, reduce its share capital, *i.e.,* it may-

(a) *extinguish or reduce* the liability on any of its shares in respect of share capital *not* paid-up; or

(b) either with, or without, extinguishing or reducing liability on any of its shares, *cancel* any paid up share capital which is lost or unrepresented by available assets.; or

(c) either with, or without, distinguishing or reducing liability on any of its shares, *pay off* any paid-up share capital which is in excess of the wants of the company; or

(d) may, if and so far as is necessary , alter its Memorandum by reducing the amount of its share capital and of its shares accordingly.

However, in the following cases, the procedure required for reduction of share capital is not called for: *(a)* where redeemable preference shares are redeemed in accordance with the provisions of Sec. 80 or Sec. 80A; *(b)* where any shares are forfeited for non-payment of calls, though the forfeiture does in fact amount to reduction of capital; and *(c)* where any surrender or gift is made to the company of its own shares.

Auditor's duty. • He should see that a special resolution for reduction of share capital has been duly passed in a validly convened meeting of the shareholders.

- He should examine the Article to ascertain whether reduction of share capital is duly authorised.
- He should see that the Court's order conf1011ing the reduction is filed with the Registrar along with the Minutes.
- He should see that the certificate from the Registrar as regards reduction of capital has been received
- He should examine the journal entries passed to give effect to the reduction of capital, and see that the assets written down are in conformity with the resolution passed at the general meeting. Also, he should verify whether the provisions. of Part I of Schedule VI as regards reduction of the value of fixed assets have been duly followed.
- He should see that reduced values of assets are properly disclosed in the Balance Sheet
- . He should check the alterations in the member’s accounts in the Register of Members and see that the amounts of their individual holdings as mentioned in the old share certificates are suitably amended or, alternatively, new share certificates are issued to them after cancellation of the old ones. He should verify whether the Memorandum of Association has been duly altered and, if the Court's order so requires, the words "and reduced" have been suffixed to the name of the company.

4.14.4 Audit of Forfeiture of Shares

If a member fails to pay any call or installment of a call on his shares the company may either *sue* him for the amount due or *forfeit* his shares, if it is empowered to do so by its

Articles. Regulations 29 to 35 of Table A provide for forfeiture of shares for failure to pay any call' or installment of a call. Regulation 35 provides that a sharer maybe forfeited for failure to pay any sum, which by the terms of the issue becomes payable at a fixed time, whether on account of the nominal value of the shares or by way of premium.

To be valid, any forfeiture of shares must satisfy the following conditions:

- ***Authorised by Articles***. Power to forfeit shares should be provided in the Articles and it should be exercised in the manner prescribed in the Articles. If forfeiture is contrary to the provisions of the Articles, it shall be void. Ordinarily, forfeiture of shares can be made only for non-payment of calls but, as held in *Naresh Chandra Sanyal* v. *Calcutta Stock Exchange* (41 Compo Cas. 5), the Articles may also provide for forfeiture on any other grounds .
- ***Prior notice***. Before forfeiting any shares, the defaulting member must be served with a notice requiring him to pay the unpaid amount of the call together with interest, if any. The notice must give a minimum of 14 days' time from the date of service of the notice, for payment of the amount due and also state that in the event of non-payment *at* or *before* the time appointed, the shares in respect of which the call which made, will be liable to be forfeited.
- ***Resolution of the Board***. If the requirements of the above notice are not complied with, the shares in respect of which the notice has been given may be forfeited by a resolution of the Board to that effect.
- ***Good faith***. The right to forfeit shares must be exercised by the directors in utmost good faith and for the benefit of company. In any case, the power of forfeiture cannot be used as a device to deprive the shareholder of his shares on his failure to pay the consideration money and in such a case the remedy open to the company is to file a suit *(Kota Transport Ltd.* v. *State of Rajasthan* 37Comp. Cas. 288).

Auditor's duty. • He must examine the Articles of the company to satisfy himself that the Board is empowered to forfeit shares.

- He should verify the amount of outstanding calls (or instalments) in respect of forfeited shares from the Share Register and the Schedule of Calls in Arrear.
- He should ascertain whether the forfeiture proceedings have been in conformity with the procedure prescribed in the Articles.
- He should check the entry in the Shares Forfeited Account and see that it is only credited with the amount actually received from the defaulting shareholder and premium, if any, received in respect of these shares is not credited to it.
- In case forfeited shares are re-issued, he should ascertain that the amount received on re-issue, together with the amount received before forfeiture, is not less than the nominal value of forfeited shares.
- In case Forfeited Shares Account shows a credit balance even after the reissue, the same should be transferred to the Capital Reserve. Account, the same being capital profit. . .

- He should ascertain that the re-issue of forfeited shares is duly authorised by the Articles and that the Board has adhered to the prescribed procedure in the matter of reallotment.
- He should check the entries as to reallotment in the Share Register.

4.14.5 Bonus shares-SEBI Guidelines

According to the Guidelines issued by the Securities and Exchange Board of India, the following provisions win apply to the issue of bonus shares:

- No bonus issue will be made within 12 months of any public or rights issue.
- The bonus issue can only be made out of free reserves built out of the genuine profits or share premium collected in cash only.
- Reserves created by revaluation of fixed assets are not to be capitalized.
- The Development Rebate Reserve or Investment Allowance Reserve can be considered as free reserve for the purpose of calculation of residual – reserves test only.
- All contingent liabilities disclosed in the audited accounts which have any bearing on the net profits will be required to be taken into account in the calculation of the residual reserves.
- The residual reserves after the proposed capitalisation will be required to be equal to at least 40% of the increased paid-up capital.
- 30% of the average profit *before* tax of the company for the previous three years should yield a rate of dividend on the' expanded capital base of the company at10%.
- The capital reserves appearing in the Balance Sheet of the company as a result of revaluation of assets, of without accrual of cash resources, are neither to be capitalised nor taken into account in the computation of residual reserves of 40% for the purposes *of* bonus issue.
- The declaration of bonus issue. in place of dividend, is not to be made.
- The bonus issue will not be made unless the partly-paid shares, if any, are made fully-paid.
- The company *(a)* must not have defaulted in payment of *interest* on existing debentures, or the *principal* on redemption thereof; and *(b)* must have sufficient reason to believe that it has not defaulted in. respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity, bonus, etc.
- A company which announces its bonus issue after· the approval of the Board of directors must implement the proposals within a period of six months from the date of such approval, and it must not have any option to change the decision.

- There should be a provision in the Articles of the company for capitalisation of reserves, etc. If it is not so, the company must pass a resolution at its general body meeting making a provision in the Articles for capita1satiort.
- Consequent· to the issue of bonus shares, if the subscribe and paid-up capital exceeds the authorised. $hare capital, resolution must be passed by the company at its general body meeting for increasing the authorised capital.
- The company must pass a resolution at its general body meeting for bonus issue, and in the said resolution the management's intention regarding the rate of dividend to be declared in the year immediately after the bonus issue should be indicated.
- No bonus issue can be made which has the effect of diluting the value or rights of the holders of debentures, whether fully convertible or partly.

4.15 AUDIT OF SHARE TRANSFER

Ordinarily, a detailed examination of transactions involving transfer of shares is beyond the scope of an audit yet, auditors are often asked to audit the transfer of shares so as to detect and prevent clerical mistakes in the registration of transfers.

The Companies Act contains a number of provisions governing transfer of shares and the auditor must be familiar with these in order effectively to carry out the share transfer audit. Some of these provisions are as follows:

- **Transfer not to the registered except on production of instrument of transfer. [Sec:108(1)].** A company will not register a transfer of its shares or debentures unless a proper instrument of transfer, duly stomped and executed by, or on behalf of; both the transferor and transferee, and specifying the name, address and occupation of the transferee has been delivered to the company. Such instrument should be accompanied by the certificate relating to the shares or debentures, and if no such certificate is in. existence, then by the letter ff allotment of shares or debentures.
- **Loss of instrument of transfer**. If on the basis of an application made to the company by the transferee, bearing the stamp required for an instrument of transfer-signed by or on behalf of the transferor, it is proved to the satisfaction of the Board of directors that the instrument of transfer signed by or on behalf of the transferor. The instrument beating the endorsement and otherwise complete, should be submitted to the company for registration within the period specified, *i.e.,* within two months from the date of endorsement in all cases *except* in the case of shares dealt in on a recognised stock exchange in the case of which a longer period is allowed.

***Restriction on acquisition and transfer of' shares of, or by, certain bodies corporate* (Sec. 108A to 180-1)**

Secs.l08A to l08G of the Companies Act are intended to regulate the acquisition and transfer of shares of, or *by* the companies to which the provisions of the Monopolies and Restrictive Trade Practices Act 1969 (MRTP Act) applies. These Sections were transferred in 198410 the MRTP Act, though now they have been transferred back to the Companies Act.

***Applicability of provisions of Sees. 108A to 108F* (Sec. l80G)**

The provisions of Sec~ l08A to l08F will apply to the acquisition or transfer of shares, or share capital, *by* or *to* any individual, firm, group, constituent of a group, body corporate, or bodies corporate under the same management who or which

(a) is the owner in relation to a dominant undertaking;

(b) would, as a result of such acquisition or transfer of shares or share capital become the owner of a dominant undertaking.

***Restriction on acquisition of shares.* (Sec. l08A).**

Every transaction of purchase of equity shares in a public company (or a private company which is a subsidiary of a public company) will require approval of the Central Government if the total nominal value of such shares *exceeds,* or *would* together with the nominal value of equity shares already held *exceed 2O%oj the paid up equity capital* of such company. The transaction as to the purchase of equity shares may be entered into by any individual, group, constituent of a group, firm, body corporate or bodies corporate under the same management [Sec. l08A(l)].

Further. there can be *no* transfer, or agreement to transfer, of any share-(a)by any company in which 51% or more of the share capital is held by the Central Government; or *(b)* by any corporation established under any Central Act; or *(c)* by any financial institution, unless the *acquirer* of such share has obtained previous approval of the Central Government for acquisition or agreement for acquisition of such share [Sec. l08A(2)].

According to Sec. 2(j) of the MRTP Act, "group" means a group of two or more individuals, association of individuals, firms trusts, trustees or bodies corporate *(excluding any* financial institution), or any combination thereof. A combination would be a group if it *exercises or* is establihed to be in a position to *excercise,* direct or indirect control over any body corporate, firm or trust. Group also means a group of associated Persons. "Associated person" of another "associated person" will also be deemed to be constituent of the group.

Accordingly, in the case of a body corporate, "associated persons" in relation to a director would mean *(a)* a relative of such director; *(b) a firm* which such director or

his relative is a partner; *(c)* any trust of which such director. Independently or together with his relatives, constitutes one fourth of its board of directors; or. *(d)* any body corporate, at any general meeting of which at least one-fourth of its directors are appointed or controlled by such director or his relatives, whether acting singly or jointly. In the case of a partner of a firm, "associated person" means a relative of such partner and includes any other Partner of such firm. In relation to the trustee of a trust, other trustees of such trust are regarded as “associated persons.

According to Explanations I, II and III to Sec. *2(g)* of the MRTP Act. Two bodies corporate will be deemed to be under the *same management,-·*

(a) if one such body corporate exercises control over the other or both are under the control of the same group; or

(b) if the managing director, director or manager of the bodies corporate is *common;* or

(c) if one such body corporate holds not less than *one-fourth of the equity shares* in the other, or *controls* the compositi0t:l of not less than one fourth of the total membership of the Board of directors of the other; or

(d) if one or more directors of one such body corporate constitute, (whether independently or together with relatives of such directors or the employees of the first mentioned body corporate), *one-fourth o/directors* of the other. (The same would be the case if 25% of the number of directors were common in both any time during the last six months);

(e) if any individual or individuals belonging to a group (whether by themselves or together with their relatives) hold *not less than one-fourth of the equity shares* in each one of the bodies corporate; or

(j) if a body corporate or bodies corporate belonging to a group (along with subsidiaries) hold not less than *one-fourth of the equity shares* in each one of the bodies corporate; or

(g) if not less than one-fourth of the total voting power in relation to each of the two bodies corporate is exercised or controlled by the same individual (whether independently or together with its subsidiaries); or

(h) if not less than one-fourth of the total voting power in relation to each of the two bodies corporate is exercised or controlled by the same individuals belonging to a group or by the same bodies corporate belonging to a group, or jointly by such individual or individuals and one of more of such bodies corporate; or

(i) if the directors of the two bodies corporate are accustomed to act in accordance with the directions of one or more of the directors of the other, or

(]) if the directors of the two bodies corporate are accustomed to act in accordance with the directions or instructions of an individual, whether belonging to a group or not.

However, while determining whether or not two or more bodies corporate are under the same management: the shares held by financial institutions in such bodies corporate shall *net* be taken into account.

If a group exercise control over a body corporate, and every other body corporate, which is constituent of or controlled by the group shall be *deemed* to be under the same management.

If two or more bodies corporate under the same management *'hold,* in the aggregate, *not. less than' one-fourth equity share capital* in any other body corporate, such other body corporate shall be *deemed* to be under the same management as the first mentioned bodies corporate.

In the case of any dispute as to whether two or more bodies corporate are *inter-connected* undertakings, or whether they ate under the *same* management the Central Government or the duly empowered Company Law Board shall decide such question.

According to Sec. *2(d)* of the MRTP Act, on undertaking will be a *dominant undertaking* if it falls within anyone of the following two categories:

(a) an undertaking which by. itself, or along with an inter-connected undertaking produces, supplies, distributes or otherwise controls *not less than one-fourth* of the total goods that are produced, supplied or distributed in India or any substantial part thereof;

(b) an undertaking which provides or otherwise controls not less than one – fourth of any services that are rendered in India or any substantial part thereof.

Restriction on transfer of shares **(Sec. 108 B)**

Every body corporate (or bodies corporate under the same management) which holds in the aggregate, *10%, or more* of the nominal value of thee subscribed equity share capital of any other company, will be required to give an intimation to the Central Government in respect of its proposal to transfer one or more of such shares. The intimation will give particulars as to the shares' proposed to be transferred, the name and address of the transferee the shares, if any already held by him in the concerned company and any other particulars as required.

If the Central Government is satisfied that as a result of such transfer, a change in the composition of the Board of directors of the company is likely to take place, and that such change *would be prejudicial* to the interests of the, company, or to public interest, it may- (a) *restrain* the transfer of shares to the person concerned; or *(b) direct* (in the case of shares held in a company engaged in any industry as specified in Schedule XV) that such shares shall be transferred to the Central Government, or to a corporation owned or controlled by the Central Government. In such a case the Government will pay the market value of the shares. However, if the Central Government does not make any direction within *sixty days* from the -date of receipt of the intimation, the provision with regard to direction by the Government will not apply.

***Restriction on transfer of shares of foreign companies* (Sec. l08C)**

A body corporate (or bodies corporate under the same management) which holds in aggregate *10% or more* of the nominal value of the equity share capital of a foreign company (having an established place of business in India) is required to obtain approval of the Central Government *before* the transfer of such shares to any, Indian citizen or a body corporate incorporated in India. The Government can *refuse* the approval if it is satisfied that the transfer would be *prejudicial* to the public interest.

Power of' Central Government to direct companies not to give effect to any transfer (Sec.108D)

If as a result of the transfer of any shares or 'block of shares of a company, there is likely to be a change in the controlling interest of the company, and if the Central Government is satisfied that such change is *prejudicial* to the, interests of the company or the public, it may direct the company not to give effect to the transfer of any such shares or block of shares. However, if the transfer of shares has already been registered, the company will not permit the transferee or his nominee, or proxy, to exercise any voting or other rights attaching to such shares. The same will be the position if the transfer of shares has *not* been ·registered.

In the case of any direction by the Central Government as stated above, the shares shall stand *re-transferred* to the transferor and he will be required to refund the price to the transferee. If he does not make the refund *within* 30 days the Central Government may also, on an application by the transferee, order the refund. The transferor will be eligible to exercise the rights attaching to the shares only *after* making the refund.

***Time within which refusal is to be communicated* (Sec. l08E)**

In the event of *non-corrt1TWnicr;ztwn* of the Central Government's *disapproval* as to acquisition of shares under Sec. l08A, or transfer of shares of foreign companies under Sec. I08C, *within 60 days from the receipt of the request* to that effect, the approval will be *presumed to have been granted.*

***Exemptions* (Sec. l08F)**

Restrictions as specified under Sec. 108A *[except* under Sec. I08A(2) *i.e.,.* restriction on transfer of shares by a company in which at least 51 % share capital is held by the Central Government or by a Corporational] will *not* apply to the transfer of any shares made *to the following,* and at the same time, *no transfer by the following,* will be subject to restrictions under Sec. l08C and 108D:

(a) any company in which 51 % or more of the share capital is held by thy Central Government

(b) any corporation established by or under any Central Act; *(c)* any financial institution.

Procedure or audit or share transfer

- ***Examination of Articles.*** The auditor should examine the Articles of the company as regards the form of Transfer Deed. He should see that it is in accordance with the form prescribed for transfer of shares under Sec. 108. He should also ascertain whether other the provisions in regard to the Form have been fully complied with.
- ***Notice to transferor(s).*** He should verify whether each transfer (in case of joint holders. each holder) has been notified by a letter in a sealed envelope, immediately after a transfer form has been lodged. He should also ascertain whether objections. if any, from the transferor(s) have been duly taken into consideration. before registration of the transfer.
- ***Notice to transferee of partly-paid shares***. Where the application for transfer has been made by the transferor and it relates to partly-paid shares, he should see that the transfer is not registered unless a notice of such application is given to the transferee and that he has made no -objection to the transfer within two weeks from the receipt of the notice [Section 110(2)].

• **Scrutiny of transfer forms**. He should examine each transfer form carefully with particular regard to the following:

(a) that the application for transfer has been made in the prescribed form and the prescribed authority has stamped the date on which it was presented to it;

(b) that in the case of quoted shares the said application was delivered to the company before the Register of Members was closed for the first time subsequent to the transfer;

(c) that in any other case, the said application was delivered to the company within two months from the date of such transfer;

(d) that cash transfer form is properly executed insofar as the names, addresses and occupations of the parties, and the name of the company, are concerned:

(e) that distinctive numbers, and description of shares to be transferred, are correctly entered;

(f) that each transfer form is dated, signed and properly witnessed;

(g) that all alteration on the transfer form have been duly initialed;

(h) that the name and address of the transferee have been given in full;

(i) that in the case of the transferee being a corporate body, its Memorandum and Articles empower it to hold shares; and

(j) that in the case of the transferee being a firm, the transfer is recorded in the individual names of the partners.

- ***Inadequacy of' consideration.*** He should see that in case consideration for any transfer is *prima facie* inadequate, the company has made enquiries to ascertain the reasons for the same. However, if the transfers form bears the seal of the Collector of Stamps, such inquiry need not be made.
- ***Comparison of transferor's signatures.*** He should compare the signatures of the transferor as given on the transfer form, with those on his application for shares, or in the transfer form under which he had originally acquired the shares being now transferred.
- ***Checking of Share Transfer Journal.*** He should check the entries in the Share Transfer Journal, particularly noting the names and addresses of the transferor and the transferee, the number and, class of shares transferred and the number of the transfer.
- ***Cancellation of transferor's share certificate***. He should see whether after the scrutiny of the share transfer form, the share certificate of the transferor has been duly cancelled so as to prevent it from being presented in support of another transfer.
- ***Letter of indemnity,*** *etc.* In case the transfer form is not accompanied by the transferor's share certificate, he should verify the letter of indemnity and other documents on thy basis of which the transfer has been registered.
- ***Examination o/Board's resolution.*** He should examine the Minutes of the meeting of the Board to verify whether all the transfers recorded in the Transfer Journal have been duly authorized by the Board.
- ***Checking of entries in Register of Members.*** He should see that entries as to the names of transferor and transferee, and the distinctive numbers of shares transferred, have been made in the Register of Members on the basis of those in the Share Transfer Journal.
- ***Rejection of transfer.*** If the right to transfer of shares is regulated by the Articles of the company or otherwise, the auditor should ensure that refusal of registration of transfer is in strict conformity "with the provisions thereof. Under Sec. 111(1) and (2), if a company refuses to register the transferor transmission of any shares or debentures, it must, *within two months* of the delivery to it of the instrument of transfer (or intimation of transmission), send a notice of the refusal to the transferee and the transferor, or to the person giving notice of such transmission
- ***Part transfers.*** Where only a part of the shares, out of the number of shares mentioned in the share certificate have been transferred he should see that the correct Balance Certificate have been issued to the transferors.

- ***Effective internal control.*** He should see that internal control as to share transfer arid other related matters, is adequately effective and it provides, *inter alia, (a)* that responsibility for duties as regards registration of transfers is widely dispersed, and every clerk bearing a part of such duties initials the documents verified by him; *(b)* that new certificates issued in place of the old ones which are lost, destroyed or defaced, bear the stamp mark "Duplicate" on them as also that this fact has been recorded clearly on the counterfoils; and *(c)* that printing and custody of shares certificate forms are under strict control of the Board.

  Transfer Jees. He should check the amount of transfer fees and compare it with the number of transfers to ascertain whether the same has been duly accounted for.

- ***Transfer of directors' shares.*** He should see that in the case of transfer of shares held by the directors, appropriate entries are made in the Register of Directors' Shareholding.

Blank transfers

A blank transfer is a transfer under which the transferor delivers to the transferee the share certificate along with a blank transfer form, *except* that he puts his own signature thereon. The date of the sale of shares and the name of the transferee is not entered in the transfer form.

One advantage of a blank transfer is that the buyer can sell it further without disclosing his identity, or paying the stamp duty, or preparing a new transfer form. This way, the purchase and sale of shares can be repeated any number of times with the help of the same original blank transfer form, until the shares reach a buyer who does not want to sell them any further and, therefore, fills in his own name as the transferee and pays the necessary stamp duty. When a blank transfer is registered, it relates back to the time when the transfer was originally made *(Howrah Trading Co. Ltd.* v. *CIT29* Compo Cas. 282). The major evils of the system of blank transfer, as painted out by the Vivian Bose Commission, are as follows:

(a) concealment of the identity of the real beneficial owners;

(b) evasion of tax by suppression of profits by way of investment in holdings on blank transfers; and

(c). window dressing of the financial statements.

According to Sec. l08(lA), enacted with a view to curbing the evils of blank transfer, there is a restriction of the period of *two months* as to the currency of blank transfers.

In *Vasudeva Ramchandra Shelat* v. *Prarrlal Jayanand Thakur* (l974) 2 S.C.C.'323], a lady gifted certain shares to a person by signing blank transfer forms which were not registered by the company before her death. The Court held that the transferee had acquired a good title to the shares, and that registration with the company was only a formality which had nothing to do with the completeness of the gift as between the parties.

4.16 TRANSMISSION OF SHARES

Transmission" means transmission by operation of law, devolution on the personal representative of a deceased person, and any other mode of transfer, not being assignment. In other words, it covers those cases where a person acquires an interest in the property by operation of law, without any voluntary act.

According to the second proviso to Sec.108(1), a company may register as shareholder any person to whom the right to any shares has passed by transmission, by operation of law. In such a case, the provision relating to transfer of shares, such as, instrument of transfer or payment of stamp duty, do *not* apply. But the discretion of the company to insist upon the proof of transmission and the power to regulate (through Articles) the procedure relating to transmission remains unaffected.

Auditor's duty. He should see that the procedure relating to transmission of shares as prescribed by the Articles has been duly followed.

- He should confirm that in the case of transmission of shares on death, the documents testifying to the authority of the legal representative have been examined by the company.
- In the case of transmission of shares on insolvency, he should ascertain whether the order of the Court and other relevant documents has been duly examined.
- He should examine the minute’s meetings of the Board in which transmission of spares has been approved.

4.17 AUDIT REPORT

4.17.1 Object of audit report

The audit report is fundamental to any audit. The· purpose of audit procedures carried out by the auditor during the course of an audit is to enable him to report to the persons who have appointed him, whether in his opinion the representations in the financial statements ate true and fair. Thus, there are two basic aspects of an audit: first, to establish the facts and, secondly, to report material facts without any fear or favour. The auditor can beheld liable for his failure to carry out satisfactory audit procedures. He can also be held liable for his failure to report facts in a clear and unbiased manner.

In the case of a company, for example, the shareholders cannot by themselves inspect the books of account on the basis Of which the financial statements of the company are prepared. Many of the shareholders are even otherwise not competent to detect irregularities in the books of account. Therefore, they appoint an auditor who is professionally competent and under a legal obligation to report to them on the truth. and fairness of the· assertions made in the financial statements. The auditor is thus duty-bound to safeguard the interests of the shareholders against an irregular activities of the management in dealing with the assets of the company. To this end, he is required - *(a)* to find out whether the management of the company has maintained proper books of

account, *(b)* whether entries have been correctly and genuinely made in the books of account, *(c)* and whether legal and accounting standards have been duly complied with in all respects.

It is incumbent on the auditor to perform his duty with great care and caution so as to ascertain whether the transactions of the company are within. the law as applicable, and as per the standards of propriety. He is required both by . law and professional code of conduct to act independently and not to do anything which might cause any loss to the interests of the shareholders, whether directly or indirectly, by aiding or abetting the management in illegal and improper dealings.

Report* v *Certificate

A certificate means a written statement made by a person having authority to make it. It may be used as proof or evidence of the thing to which it relates. A high degree of exactitude and precision is the basic ingredient of a certificate which, therefore, assumes the character of a guarantee to the effect that the matters certified are indeed what they appear to be.

An audit report is *not* a certificate. It only contains the *opinion* of the auditor as regards the representations made in financial statements and matters relevant thereto. It does not certify - that the financial statements *really* or *necessarily* present what they claim to present Event otherwise, the auditor does not, indeed cannot, provide a guarantee that the facts and matters represented in the financial statements are wholly and truly what they are represented to be.

No doubt, the auditor may give a certificate on matters such as the value of imports and exports, return of deposits, bonus computation, etc. But this is only because it is possible to arrive at fairly precise conclusion with respect to them.

Contents of audit report

The auditing standard as regards audit report applies to all reports in which the auditor is required to express his opinion on financial statements intended to ' give a true and fair view of the state bf affairs, profit or loss, etc.' But it does not override the statutory provisions regarding any other matters to be included in the report in the case of any specified class of enterprises.

Accordingly, the report should identify the persons to whom it is addressed and the financial statements to which it relates. Secondly, the auditor should refer expressly in his report to the following:

(a) whether the financial statements have been audited in accordance with generally accepted auditing standards and practices;

(b) whether in his opinion the financial statements give a true and fair view of the state of affairs, profit or loss and, where applicable, source and application of funds; and

(c) any matters prescribed to be included in his report according to the relevant law or other requirements.

4.17.2 Audit Report under Companies Act

Under Sec. 227(2), the auditor is required to make a report to the members of the company

(a) on the accounts examined by him;

(b) on every' Balance Sheet and Profit and Loss Account, Which are laid before the company in general meeting during his tenure of office; and

(c) on every document declared to be a *part* of, or *annexed* to the Balance

Sheet and Profit and Loss Account

The auditor's report must state whether in *his opinion* and to the *best of his information,* and according to the *explanations given to him,* the said accounts give the information, required by this Act *in the manner so required,* and give a *true and fair view* -

(a) in the case of the Balance Sheet, of the state of the company's affairs as at the end of the financial year; and

(b) in the case of the Profit and Loss Account, of the profit or loss for the financial year.

Two parts of the audit report

According to the legal requirements as .regards an audit report, the report has to be' in two parts, namely, *(a) scope* of the audit; and *(b) opinion* of the auditor as regards financial statements.

Scope part: The fist part of the standard audit report describes the scope of the audit and the statements examined. It states in a matter-of-fact manner what was examined and how. In the case of a company audit, the subject-matter of audit examination are the accounts and Balance Sheet and Profit and Loss. Account as it whole. This is prescribed under the law and the scope of the examination cannot in any way be curtailed.

Accordingly, the auditor is requited to state in his report-

(a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination, and proper returns adequate *fat* the purposes of his audit have been received from branches not visited by him; .

(c) whether the report on the accounts of any branch, audited under See. 228, by a person *other than* the company auditor, has been forwarded to him and how he has dealt with the same in preparing his report; and '

(d) whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

Distinction between documents 'annexed" and "attached". It is to be noted that Sees. 216 and 222 refer to the documents to be *annexed* and *attached* to the Balance Sheet. The documents *annexed* to the Balance Sheet include-(a) the Profit and Loss Account; *(b)* list of investment and particulars required by See. 3{2(9) ; and *(c)* any information given in a: "schedule" where permitted to this effect. The documents *attached* to the Balance Sheet include -. *(a)* the documents and statements relating to subsidiary companies specified in See. 212; *(b)* the directors' report; and *(c)* the auditor's report.

'The auditor's report only covers documents which are *annexed* to the Balance Sheet It do *not* cover documents which are *attached* to it

• ***Opinion part.*** The second part of the standard audit report is concerned with expressing the auditor's opinion with regard to the object of review. The opinion' covers the truth and fairness of the accounts and Balance Sheet and Profit and Loss Account, their conformity with the generally accepted accounting principles and legal provisions, maintenance by the company of proper books of account as required by the law, branch accounts not directly audited by him, and consistency of the accounts, Balance Sheet and Profit and Loss Account with the books of account and returns.

The opinion expressed in the audit report should be clear and unequivocal. For example, if the auditor issues an *unqualified* opinion, it would be enough to say that in his opinion the financial statements *do* present a true and fair view of the .state of affairs and the results of operations. But if he issues a *qualified* opinion are states that in his opinion the Balance Sheet or Profit and Loss Account does not-present a true and fair view, then he must also call attention precisely to what is wrong and where. For any equivocation or ambiguity in his report he may be held guilty as held in the *London and General Bank* case in 1895.

4.17.3 Special Matters To Be Included In Audit Report

In addition to the requirements of Secs. 227(2) and (3), the auditor may also be required to report his opinion in regard to certain other matters. This can be in respect of certain specified transactions of the company, or special matters in the case of banking, insurance electric supply, manufacturing and other companies.

1. Matters required being included in audit report in certain cases

   Under Sec. 227(l-A), the auditor is required to *inquire* and *report* on:

(a) loans and advances made by the company on the basis of security in case these are *not* properly secured, or if their terms *are prejudicial* to the interest of the company;

(b) transactions of the company represented merely by *book entries* in case they are *prejudicial* to the interests of the company;

(c) sale of shares, debentures and other securities by a non-investment company, in case the sale price is *less* than the purchase price;

(d) loans and advances made by the company, though' shown as *deposits;*

(e) charging of *personal expenses* to revenue accounts; and

(f) the amount of *cash received against shares* allotted for cash and the amount of outstandings.

However, the auditor is *not* obliged to express his opinion on these matters, unless he has any special comments to make about them.

2. Matters to be included in audit report in the case of banking, insurance and electric supply companies.

In the case of audit of banking, insurance and an electric company, the auditor must also state in his report the following matters:

In the case of a banking company [Sec. 30(3) of Banking Regulation Act] -

- Whether the auditor .ha~ obtained *all the information an4 explanations* which, to the best of his knowledge and belief, were necessary for the purposes of his audit, and has found them to be satisfactory.
- Whether the transactions of the bank which have come to his notice, have been *within the powers* of the bank.'
- Whether in his opinion *proper books of account* as required by law have been kept by the bank so far as appears to him from his examination of these books, and *proper returns* adequate for the purposes of his audit have been received from the branches of the bank.
- Whether the bank's Balance Sheet and Profit arid Loss Account dealt with by his report are *in agreement with* the books of account and the returns.
- Whether the: reports on the *accounts a/the branches* audited by We branch auditors have been forwarded to him and the same have been considered by him in preparing his own report.
- Whether in his opinion, and to the best of. His information and according to the explanations given to him, the said accounts give the *information required* in respect of the banking companies, and on such basis the said Balance Sheet gives a true and fair view of the state of affairs of the bank as on the last day of the financial year and the Profit' and Loss Account shows a true and fair view of the profit of loss for the year ended on that date.

In the cast of a nationalized bank:

- Whether, in the opinion of the auditor, the Balance Sheet is a *true and fair Balance Sheet* containing the *necessary particulars* and it is *properly* drawn up so as to exhibit a true and fair view of the affairs of the bank; and the Profit and Loss Account shows a *true balance of profit.*
- Whether he has obtained *all the information and explanations* which to the best of his knowledge and belief were necessary for the purpose of his audit and which he finds to be satisfactory.

- Whether the transactions of the bank which have come to his notice have been *within the powers* of the bank.
- Whether the *returns received from the offices and branches* of the bank have been found adequate for the purpose of audit.

In the case of insurance and electric supply companies:

In the case of *insurance* and *electric supply companies* also; there are provisions in the Insurance Act and the Electricity (Supply) Act specifying the matters in respect of which the auditor is required to report.

In the case of manufacturing and other companies:

In exercise of the powers conferred by Sec. 227(4A), the, Central Government has issued the *revised* Manufacturing and Other Companies (Auditor's Report) Order (MAOCARO) 1988, providing for inclusion of certain specific matters in the audit reports in the case of companies engaged in the following business:

(a) manufacturing, milling or processing;

(b) supply and rendering services;

(c) trading; and .

(*d)* financing, investment, chit fund; *nidhi* or mutual benefit societies.

The Institute of Chartered Accountants of India has issued a Statement to enable the auditors to comply with this Order.

The auditor's report on the accounts of the company to which this Order applies, shall include a statement on the following matters, namely:

A. In the-case of a manufacturing; mining, or processing company:

- Whether the company is maintaining *proper records* to show full particulars, including quantitative details and situation of fixed assets; whether these fixed assets have been *physically verified'* by the management, and if any serious discrepancies Were noticed on such verification, whether the same have been properly dealt within the books of account.
- In case any of the fixed assets have been revalued during the year, the *basis of revaluation* should be indicated.

- Whether *physical verification* has been conducted by the management at reasonable periods in respect of finished goods, stores spare parts and raw materials, and whether the procedures of physical verification employed by the management are reasonable and adequate in relation to the size and nature of the business. If any significant discrepancies have been noticed on such verification as compared to book records whether the same have been properly dealt with in the books of account. Whether the auditor is satisfied that the *valuation* of these stocks is fair and proper in accordance with the normally accepted accounting principles and is on the same basis as in the earlier years. If there is any deviation on the basis of valuation, the effect of such deviation, if material, is to be reported.
- If the company has *taken* any loans, secured or unsecured, ·from companies, firms, or other parties listed in the Register maintained under Sec. 301 and/or Sec. 370(lC) of the Companies Act, whether the rate of interest and the terms and conditions of such *Loans are, prima facie, prejudicial to the interest o/the company* .
- If the company has grated any loans to companies, firms, or other parties listed in the Register maintained under Sec.301 and / or Sec. 370 (lB), whether the rate of interest and other terms and conditions of such loans are, *prima/acre, prejudicial to the interests of the ·company.*
- Whether the parties, to whom the loans (or advances in the nature of loans) have been given by the company, are *repaying* the principal amounts as stipulated and are also regular in the payment of interest and, if not, whether reasonable steps have been taken by the company for recovery of the principal and interest.
- Whether there is an *adequate internal control procedure;* commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials including components, plant and machinery, equipment and other assets, and for the sale of goods.
- Whether the transactions of *purchase* of goods and materials and *sale* of goods, material and services made in pursuance of contracts and arrangements entered in the Register maintained under Sec. 301 (aggregating Rs. 50,000 or more during the year in respect of each party) have been made *at prices which are reasonable, ·having* regard to the prevailing market prices for such goods, etc., or the prices at which similar transactions have been made with other parties.
- Whether any *unserviceable* or *damaged* stores or raw materials or finished goods are determined, and whether *provision for* the loss, if any, has been made in the accounts.
- In case the company has accepted *deposits* from the public, whether the· directives issued by the Reserve Bank of India and the provisions of Sec. 58A of the Companies Act 1956, and the rules framed there under (where applicable), have been coroplie4 with. If not, the nature of contraventions should be stated.

- Whether the company is maintaining reasonable records for the *sale* and *disposal of realizable by-products and scraps,* where applicable.
- In relation to companies, the *paid up* capital of which' at the commencement of the financial year concerned exceeds *Rs; 25 lakhs,* or which has an *average* annual turnover exceeding *Rs.* 2 *crore* for a period of *three* consecutive financial years immediately preceding the financial year, whether the company has an *internal audit System* commensurate with its size and the nature of its business.
- If maintenance of *cost records* has been prescribed by the Central Government under Sec. 209(1) (d) of the Companies Act, whether such accounts and records have been maintained.
- Whether the company is regular in depositing *provident fund* and *employees' state insurance dues* with the appropriate authority and, if not, the extent of arrears of provident and ESI dues shall be indicated by the auditor.
- Whether any *undisputed amounts* payable in respect of income-tax wealth-tax, customs duty and excise were *outstanding* as at the last date of the financial year concerned, for a period of more than *six months* from the date they became payable. If so, the amounts of outstanding dues should be reported.
- Whether *personal expenses* have been charged to revenue accounts; if so, the details thereof should be reported.
- Whether the company is a *sick industrial company* under Sec. 3(1) (0) of !he Sick Industrial Companies (Special Provision) Act, 1985. If so, whether a reference has been made to the Board for Industrial and Financial Reconstruction. under Sec. 15 of that Act

B. In the case of a service company:

- All the matters specified in the case of manufacturing, mining or Process Company to the extent to which they are applicable.
- Whether the company has a reasonable *system of recording* of receipts issues and consumption of materials and stores and of *allocating* materials consumed to the relative jobs, commensurate with its size and nature of business.
- Whether the company has a reasonable system of *allocating man-hours* utilised to the relative's jobs, commensurate with its size and nature of its business.
- Whether there is a reasonable system of *authorisation* at proper levels, and an *adequate system of internal control* commensurate with the size of the company and the nature of its business, on the issue of stores and allocation of stores and man-hours to the relative jobs.

C. In the case of trading company:

- All the matters specified in the case of a manufacturing mining or process company to the extent to which they are applicable:
- Whether *damaged goods have been determined*, and if the value of such goods is significant, whether provision has been made for the loss.

D. In the case of a finance, investment; chit fund, nidhi, or mutual benefit company :

- All the matters specified in the case of a manufacturing, mining or process company to the extent to which they are applicable.
- Whether adequate *documents and records* are maintained in a case where the company has granted *loans and advances* on the basis of *security* by way of pledge of shares, debentures and other securities.
- Whether the provisions of any *special Statute* applicable to Chit Fund, Nidhi or Mutual Benefit Society have been duly complied with.
- If the company is dealing or trading in shares, securities, debentures and other investments, whether *proper records* have been maintained of the transactions and contracts, and whether timely entries have &.-en made therein. Also, whether shares; securities, debentures arid other investments have been held by the company in its own name, except to the extent' of the exemption, if any, granted under' Sec. 40 of the Companies Act.

Types of Opinion

In the opinion part of the audit report, the auditor expresses his opinion whether the accounts and Balance Sheet of the company reveal a true and fair: picture of the state of its affairs and the results of its operations.

The opinion expressed by the auditor may be classified as -

(a) unqualified,

(*b)* qualified,

(c) adverse or negative,

(d) disclaimer.

4.17.4 Unqualified Report

If the auditor is satisfied that the accounts and Balance Sheet and Profit and Loss Account *do* present a true and fair picture of what they purport to present, and that they are wholly in' conformity with the accounting principles and statutory requirements, he will give an *unqualified* or *clean* opinion, *i.e.,* without any qualification or reservation.

Thus, if the auditor in his reportma.1ces a statement to the effect that "in our opinion and to the best of our information and according to the explanations given to us, the Balance

Sheet and Profit and Loss Account give a true and fair view of the state of affairs and the results of operations", he 'Will be said to have given an unqualified opinion and his report will be called an *unqualified* or *clean report.*

As a matter of general principle, an auditor issuing an unqualified opinion should not make reference to any specific aspect of the financial statements in the body of his report, as the same may be misunderstood as a qualification. However: in certain cases, the reader of the report will obtain a better understanding of the financial· statements if his attention is drawn to important matters, such as, any unusual events accounting policies, etc.

In India, the actual practice in the case of audit generally is that the auditor makes a' formal report adopting the bare language of Sec. 227, without expressing any reservation to it, *i.e.,* he issues an *unqualified* opinion.

A specimen of an unqualified or clean report is given below:

March, 1994 and the Profit and Loss Account of the company for, the financial year ended on that date· as annexed thereto, in which are duly incorporated the audited accounts of three branches of the company which have also been audited, and report that -

(a) we have obtained all the information and explanations which. to the best of our knowledge and belief were necessary for the purpose of our audit;

(b) 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;

(c) the report of the accounts of the three branches audited by other auditors have been forwarded to us and have been considered by us in preparing our report;

(d) the Balance Sheet and the 'Profit and Loss Account dealt w1th by this report are in agreement with the books of account; and

(e) in our opinion and to the best of our information and according to the explanations given to us, the accounts give the information requited by the Companies Act. 1956, in the manner so required and give a true arid fair view-

(i) in the case of Balance Sheet, of the affairs of the company as on 31&t March, 1994; and.

(ii) in the case of Profit and Loss Account, of the profit for the year ended on that date.

For SANDHYA-RAMESH ASSOCIATES
P.Ramesh
Auditors

15th July, 1994 The qualifications in the report. if any, should be added in clause *(e)* of the report, modifying its language accordingly, ,and explaining the same by means of a note.

4.17.5 Qualified Report

When the auditor is unable to report affirmatively on the matters contained in the Auditing Standard (namely, whether in his opinion the financial statements give a true and fair view of the state of affairs , profit or loss, and whether legal and other provisions, as applicable, have been complied with) he should *qualify* his report referring to all material matters about which he has reservations. He should also 'give all *reasons* for his qualification together with a qualification of its effect on the financial statements, if the same is relevant and practicable. Reference may also be made about non-compliance with the relevant laws and other requirements.

• ***Nature of qualification***. A qualified report should not leave the reader in any doubt as regards its meaning and its implication for an understanding of the financial statements. The nature of circumstances giving rise to a qualification of opinion will generally fall into· either of the following
categories:

(a) there is an. uncertainty. which prevents the auditor from forming an opinion on any matters (uncertainty), or

(b) thought the auditor is able to form an opinion on a matter, but this conflicts with the view given by the financial statements (disagreement).

According to 'Sec. 227(4), where the answers to the queries given under Sec. 227(2) and (3) are in the negative, or with a qualification, the auditor will have to state the reasons for the same.

A qualified opinion will be given where -

(a) the accounts and the Balance Sheet and Profit and Loss Account do not present truly and fairly the state of affairs and results of operations, either due. to *lack of conformity* with the generally accepted accounting principles, or because the disclosure therein is *inadequate* or *incomplete* as per the statutory requirements, or because it is *biased;* or

(b) proper books of account as required by law have *not* been maintained; or

(c) part of the audit examination has been made by other auditors.

A qualified opinion will be issued in a circumstance' when, in order to convey the results bf his audit, the auditor needs to depart from the form of 'wording normally used for unqualified audit reports. But it is necessary that he should state the nature of qualification, *i.e.,* the reason for the qualification, the subject of the qualification and its materiality. The Institute of Chartered Accountants in its Statement on "Qualifications in Auditors' Reports" has" provided that before making a qualified report, the auditor must carefully consider various aspects in proper perspective. For example, he should see *(a)* as to which of the various items, statements of fact and opinion, require a qualification ; *(b)* whether he is in active disagreement with something which has been done by the

company, or is merely unable to form an opinion in regard to items for which there is lack of adequate information; *(c)* whether the matters in question are so material as to affect the presentation or a true and fair view of the whole of the affairs of the company, or they are of such a nature as only to affect a particular item disclosed in the accounts; and (d) whether matters constituting qualification involve a material contravention of any requirements of the Companies Act, 1956 which have a bearing on the accounts .

• ***When to qualify the report.*** In quite a few cases, "the items which are the subject-matter of qualification are not so material as to affect the truth and fairness of the whole of the accounts, but merely create uncertainty about a particular item. In such cases, the auditor need only state that in his opinion, but *subject to* the specific qualifications mentioned, the accounts present a true and fair view. However, in some cases, expression of the "subject to" opinion may become meaningless in view of the substantial materiality of the items involved. For example, if the auditor is not able to examine a large part of the books of account because they are· in police custody, it would not serve any purpose to express an opinion on the truth and fairness of accounts and then to follow it by a statement that the" books of 3C.count have *not* been examined. In such a case, the auditor should *(a)* report that he is unable to state whether the accounts present a true and fair view: or *(b)* make a categorical statement that in his opinion the accounts go *not* present a true and fair view.

How to qualify the report. While' qualifying his report, the auditor should give full information about the subject-matter of his qualification and not merely create grounds for suspicion or inquiry and leave it to the shareholders to ascertain the facts by diligent inquiry. He is required to give "information", and not merely the "means to information."

It is customary to qualify the auditor's report by the use of expression such as "subject to" or "except that" so as to ensure a degree of uniformity and assist the public in evaluating the contents of the report. The expression, "read with the notes thereon" *or* "together with the notes thereon" are merely explanatory and do *not* amount 0 to' qualification. In any case, notes to accounts ordinarily represent the explanatory statements given by the directors of the company and hence should not contain the opinion of the auditor.

A qualified report should not be cluttered with irrelevant facts and information that might confuse the shareholders as regards the items involved and their effect on the overall presentation. At the same time, it should also not be too brief so as to mislead the shareholders. Vague statements which say nothing about the effect of the item involved on the accounts should be avoided, *e.g.,* "Debit balances are subject to confirmation" or "Payment vouchers have been accepted by us as passed by the manager;"

The auditor should exercise independent judgment and express his opinion irrespective of the views held by the directors and, also without regard to any consequences which the qualifications may have as to the financial standing of the company. Though it is an unpleasant task to render a' qualified report; the auditor has to perform it and he cannot in any circumstance escape it. He also cannot refuse to submit the report. He may resign before making a qualified report but his decision should be keeping in view his ethical responsibilities under the facts and circumstances of the case.

If the auditor has 'decided to submit a qualified report, it is desirable that he should discuss the contents of the report with the company's management and make his views clear so that an opportunity may be provided to the Board of directors to consider the issues involved, meet the objections raised or to offer their explanation. This will enable the auditor to frame the qualification more accurately and pointedly.

• ***Circumstances when qualified report is obligatory***. There may be circumstances in which the auditor may be obliged to qualify the report. Important among these are as follows:

(a) If the auditor is unable to obtain all the information and explanations which he considers necessary for the purpose of his audit.

(b) If proper books of account have not been kept by the company in accordance with the law.

(c) If the Balance Sheet and Profit and Loss Account are not in agreement with the books of account and returns.

(d) If information required by law is not furnished.

(e) If the accounts do not disclose a, true and fair view.

(j) If there is contravention of the provisions of the Companies Act, having a bearing on the accounts and transactions of the company.

Below, a specimen of a qualified report:

Auditor's report to the members of Astha-Marshall Combine Ltd.

We have audited the Balance Sheet of *Mis.* Astha Marshall Combine Ltd. as at 31st March, 1994 and the Profit and Loss Account for the financial year ended on that date as annexed thereto. .

A reference concerning imposition of an additional sales-tax liability on the company to the tune of Rs. 75lakhs in respect of the financial year 1991-92 is pending disposal by the High Court.

Subject to any adjustment to the Balance Sheet and Profit and Loss Account which may be necessitated by the final determination of company's sales-tax liability as indicated above, in our opinion, the financial statements' give a true and fair view of the company's state of affairs as at 31st March 1994, and of its profits for the year ended on that date.

Adverse or Negative Opinion

An adverse or negative opinion will be given. when there is a sufficient basis for the auditor to form an opinion that the accounts and financial statements, taken as a whole, do *not* present a true and fair view of the financial condition and results of operations. This will be the case where there is-(a) a substantial departure from the generally accepted accounting principles; or *(b)* a material mis-statement in the statements; or *(c)* an omission of a material disclosure. In fact, the rule is that where the reservations ate so material that rendering, a qualified opinion would *not* serve the purpose, the alternative is to make an adverse report

Even so, an adverse opinion is 'quite drastic and should only be made in rare cases. But where it becomes unavoidable, the auditor must disclose all the reasons which have obliged him to make such a report below, a specimen of an adverse report:
Auditors' report the members of Astha-Marshall Combine Ltd.

.

We have audited the Balance Sheet of *Mls.* Astha-Marshall Ltd. as at 31st March, 1994 and the Profit and Loss Account for the financial year ended on that date as annexed thereto, *except* that the scope of our work was limited. by the matter referred to below :

"While the proceeds of sales are collected by the company on installment basis over a five-year period, the total amount of sales is credited to the Sales Account at the time of sales. However, for the purposes of income-tax, only the actual sums realised during the year are taken into account and no provision' has' been made for tax liability as regards unpaid installments to be collected in future. Had this been done, the net profits would decline by Rs. 85 lakhs and the Balance Sheet would include' a liability in respect of income-tax on unpaid installments to the tune of Rs.36 lakhs."

"Considering the mated-ally of the amounts omitted on account of' income-tax as-described above,' we are of opinion that the Balance Sheet and the Profit and Loss Account do *not* exhibit a' true al1d' fair picture of the financial condition as on 31st March 1994 or the results of operations for the year ended on that date."

DISCLAIMER

When the auditor does not have sufficient information to serve as the basis of his opinion, he may disclaim an opinion on the accounts and Balance Sheet and Profit and Loss Account accordingly, he may state that he has *not* been able to obtain sufficient information to form an opinion as regards the financial statements.

Insufficiency of information for the purpose of forming an opinion may be *(a)* because the audit examination itself is, n*ot* adequate for the purpose of expression of art opinion; or *(b)* because, even though the audit examination may be adequate, there are some *material indeterminate items* which make fair presentation impossible.

A disclaimer of opinion is common in case of non--statutory audits where the scope of audit examination may be limited by the client. But whether a ' disclaimer is in the c~ of statutory or non-statutory audit, the reasons for it must be given in each case.

Below, a specimen of a disclaimer:
Auditors' report to the Astha-Marshall Combine Ltd.

"We have audited the Balance Sheet of Astha, Marshall Combine Ltd. as at 31st March, 1994, and the Profit and Loss Account for the year ended on that date as annexed thereto.

"The company is involved in a major litigation with the dependants of its 500 workers who died and about 2,000 of its workers who were disabled due to leakage of a poisonous gas in its plant. The liability as to damages is difficult to quantify and, in any case the company has not made arty provision for the same."

"In the circumstance we cannot and do not express any opinion on the Balance Sheet and Profit and Loss Account.

4.18 CHARACTERISTICS OF A GOOD REPORT

To write a good report, a thorough knowledge of the principles and practice of accounting and auditing is essential. What is equally necessary is sincerity of purpose, clarity in thinking, accuracy, simplicity, brevity, and coherence in expression.

• Sincerity of purpose

The company auditor is primarily concerned with expressing an opinion as to whether the financial statements of the company present the financial information truly and fairly in conformity with accounting principles and legal requirements. He should, therefore, ensure that the opinion contained in his· report bears, both in fact and appearance, the impress of an independent mind, unaffected by any bias.

• Clarity in, thinking

It is an important pre-requisite of clarity of expression. The report of the auditor is meant for a wide variety of people who may be otherwise quite intelligent; but for most of whom the data presented in the financial statements may be Greek and Latin. The auditor has therefore, to act as their friend, philosopher and guide. His report must inform them about the existing state of, affairs of the company. It must assure them that the presentation contained in the financial statements has, upon reasonable analysis of the company's accounts and, records, been found to be true, and fair. It must also caution them about things which, though material; have not been mentioned in the financial statements. And it must do this in a language that is at once dear even to a layman avoiding the use of long words and phrases.'

• Accuracy

The point that the audit report must be accurate in every respect cannot be over-emphasised. Strict standards of accuracy must be maintained in collection, interpretation, and presentation of data in the audit report.

• Simplicity

It flows from sincerity of approach to issues and conviction in the conclusions expressed. Complicated style of writing is the mirror of a confused mind which cannot think: straight. The auditor must be able to present even a complicated mass of figures and

information in a simple way. This calls for translation of his conclusions into simple words and phrases. Frequent use of long or difficult words and phrases should be avoided as it causes dullness besides making the report appear less than genuine.

• *Brevity*

Brevity in word, in phrase and in sentence will make the report live and interesting. Moreover, it will save its readers, many of who are busy people and in a hurry to get at the substance of the matter at once, precious time and energy. Brevity is achieved by revising the report over and over again, cutting out the unnecessary detail and tying up the loose ends.

• *Coherence*

The report must be coherent so as to achieve maximum effect It 'must stick together. There must be a thread of unified thought binding sentence to sentence, and paragraph to paragraph. This again is achieved by revising the subject-matter of report again and again such that every word, every sentence and every paragraph of it becomes fittingly appropriate.

Review Questions.

1. What are the provisions in the Companies Act for the appointment of an auditor of a company?
2. Describe the disqualifications for appointment as an auditor of a company.
3. Write a note on remuneration of auditor.
4. Describe the various rights conferred on a company auditor.
5. Enumerate the various duties of a company auditor.
6. Define audit report. What are its contents?
7. Write a note on a qualified audit report.
8. What are the principles of good report?

UNIT- V

LESSON-5

INVESTIGATIONS

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5.0 AIMS AND OBJECTIVES

This final unit contains the part of investigations which means a close examination of the accounts and records and a search for the relevant data, and its objectives. Different kinds of investigations and specific investigations are explained. Special audit and statutory investigations are followed with Electronic audit, with its benefits and legal authority.

5.1 INTRODUCTION OF INVESTIGATIONS

5.1.1 Nature of Investigations:

An investigation may be defined as a close examination of the accounts and records and a search for the relevant data, with a view to ascertaining any fact for some special purpose, e.g., to acquire authoritative information, or seek conformation in regard to a stated fact, or resolution of a doubt. Being a special-purpose examination, it has some exclusive features which are as follows:

5.1.2 Scope

The scope of an investigation is limited as regards the period or areas to be covered. An investigation on behalf of a person intending to buy or sell a business will, for example, be only concerned with determination of the value of the assets, reserves and liabilities of the business and its existing potential and future prospects. An investigation as regards suspected irregularities in cash transactions or theft of property will, on the other hand, only deal with relevant matters over a brief period.

5.1.3 Object

The object of an investigation is to collect, analyse and evaluate facts relating to some special purpose as determined by the person on whose behalf the investigation is undertaken. Thus, it may deal with the proposed purchase or sale of a business, causes of low profitability or high employee turn over, reliability of business data, proposed investments, a suspected fraud, etc.

5.1.4 Audit programme

It is not possible to lay down a standard audit programme as regards an investigation. As investigation is qualitatively different from the other depending on its object, the contents of the programme will have to be suitably designed in the light of availability of the required data, as also the situation emerging as the work progresses.

5.1.5 Auditing procedures

There are extraordinary and extended audit procedures in the case of an investigation and their object is to collect the facts and circumstances relevant to the issue and test their veracity according to strict standards of proof. The generally accepted auditing procedures have sometimes to be bypassed in an investigation, as the same may not be adequate for the purpose.

5.1.6 Approach to work

An investigation proceeds along a specific frame of reference, such as: What is the true worth of a business proposed to be bought or sold? Are the business data reliable? Is there indeed a fraud as suspected? Does a business make a rewarding investment proposition? And so on. The auditor is only required to collect, analyse and evaluate the facts relevant to it. He works on a narrow canvas, concentrating only on the issue under investigation, to the exclusion of all the rest. Unlike a general audit a auditor does not prima facie believe the data and information as presented to him or collected by him to be true. He subjects the entire data and information to a close scrutiny, applying far stricter standards of evidence and proof. He must also be able to look beyond and beneath the surface, and trace the right clues to get at the desired information.

5.1.7 Report

The report of the investigation is made to the person on whose behalf the investigation has been undertaken. It is in the form of a summing up of the conclusions drawn on the basis of the enquiry in to specific facts and circumstances. There is, however, no standard form for making the report.

It is also not necessary for the auditor to express any opinion of his own. But he must provide adequate material for the client to make a proper judgment. In an investigation on behalf of a person intending to buy a business, fro example the auditor need not say whether the business is worth buying, or whether it is worth the price demanded. But since the investigation report will form an important basis for judgment by the client, the auditor must present his conclusions and the evidence supporting the same, in a clear and cogent manner.

5.2 DISTINCTION BETWEEN AUDIT AND INVESTIGATION

Criteria	Audit	Investigation
Scope	Quite wide. In statutory audit, the scope is determined by the relevant law, and in a private audit, by the client.	Limited as regards the period or areas to be covered.
Object	Generally to verify the truth and fairness of the presentation in the financial statements on the basis of the accounts and records examined.	To conduct the close examination of relevant records and other evidence to ascertain any fact for some special purpose.
Audit programme	Generally a standard programme, with scope for modification depending on the type of business.	No standard programme.
Auditing procedures	Generally accepted auditing procedures.	Extraordinary and extended auditing procedure.
Approach to work	Prima facie evidence is generally accepted as true unless there is anything to the contrary.	Prima facie evidence is never accepted as true until it has been subjected to a close security.
Report	It gives the auditor's opinion as regards the truth and fairness of the presentation in financial statements.	It is only a summing up of the conclusions on the basis of the enquiry. Expression of any opinion is not necessary.

5.3 CLASSIFICATION OF INVESTIGATION

Investigation may be classified as:

- Evaluations
- Reviews
- Surveys
- Analyses
- Special audits
- Statutory investigation.

Evaluations

An evaluatory investigation may be aimed at determining the worth of the business proposed to be bought or sold, or the ability and the efficiency of the personnel or machinery, etc. In the case of a business proposed to be bought, the investigation relates to valuation of assets and liabilities, and determining the current earning potential and future

prospects of the business. In the case of sale of a business, it relates to determining the net worth of the business. Investigation as regards evaluation of personnel or machinery, will deal with determining the ability and efficiency of human and physical resources as against the projected performance on their part.

Reviews

An investigation by way of a review may be conducted either to ascertain the compliance with the terms of a contract or to determine the reliability of business data.

For example, the secured creditors of a company may engage the auditor – (a) to investigate the company's compliance with the deed creating a charge on the assets of the company in their favour; or (b) to interpret the technical terms in the deed. Persons entitled to payments of royalty or commission as a percentage of the output or turn over, may similarly appoint the auditor to investigate the correctness of the data furnished by the company.

Surveys

An investigation by way of a survey will be undertaken to measure and map out a wide range of matters, such as, the accounting and cost systems, employees of the business, etc.

A survey of the accounting system may be under taken as a follow up of the audit report pointing to the weaknesses of the system. It may also independently be ordered with a view to installing an effective budgetary control system.

A survey as regards the cost system may be undertaking to study the inadequacies of the existing procedures of inventory pricing or allocation of various overheads, and to determine suitable alternatives.

A survey as regards employees of the business may be undertaken to identify their personality traits such as experience, aptitude, initiative, leadership, etc., and to determine a suitable incentive scheme to promote individual and group efficiency.

Analysis

An investigation by way of carrying out an analysis of the available data and information may be undertaken to facilitate decision making by the management in certain vital areas, such as, determination of the cost or price of products or services. This will call for the great deal of research to identify the factors responsible for increase in the cost or price, and determination of the ways in which these may be controlled.

Special audits

Investigations falling under this category are usually undertaken to determine fraud, though these may also pertain to losses caused by fire or machinery break down, aimed at filing a claim with the insurers.

Cash and inventory records are the most susceptible to commission of fraud. An investigation in this area generally covers a short period, between three and six months.

Investigations as regards losses are concerned with determining the factors responsible for the losses as also computing the amounts involved, so as to facilitate the filing of claims with the insurers.

Statutory investigation

These have been provided under Secs. 235 to 251 of the Companies Act 1956, accordingly, the affairs of the company may be investigated by the Central Government – (a) on an application by the members; (b) on a report by the Registrar of Companies; or (c) on an order by the competent court.

An investigation into the affairs of the company means an investigation of all its business affairs such as profits and losses, assts including goodwill, contracts and transactions, investments and other property interests.

The nature and scope of a statutory investigation, the powers of the inspector appointed to conduct the investigation, and scope and purpose of the report are duly provided under the Company Law.

The following points as regards conduct of an investigation should be carefully borne in mind:

Object

Before commencing an investigation, the auditor should be clear about the object and scope thereof and insist on these being reduced to writing so as to avoid any future misunderstanding or liability.

Audit Programme

It is not possible to prepare a standard audit programme in the case of an investigation. However, the auditor should be able broadly to map out the lines along which the work is to proceed. The course of investigation should be capable of being modified or altered in light of new data and information. Working papers relating to the investigation should be carefully reviewed from time to time to see that the work is proceeding as desired.

Auditing Standard

An investigation constitutes an extra-audit service, but this will in no way minimize the liability of the auditor to comply with the auditing standards of competence and due care. If the author offers his services in a non-audit area which he is not adequately competent, he may be held guilty of breach of professional ethics and also liable for damages.

Due care and caution

The obligation of due care and caution is inherent in the entire investigation assignment. The auditor should be careful in evidence-gathering, analysis and evaluation. In areas where he lacks adequate competence, such as valuation of assets and liabilities, he should seek expert’s opinion from outside. In any case, his conclusions should be based on an adequate competent evidentiary matter.

Fairness

It is not possible to define “fairness”, but it refers to professional integrity of the auditor. It arises from independence in mental attitude which imparts objectivity and fairness to his conclusions.

Adequate reporting

The report of the investigation should provide a clear indication of the character of the examination and the extent to which the auditor is prepared to own responsibility. The client greatly relies on the report of the auditor. As such, the report should lay down the conclusions clearly and precisely and also provide adequate evidence to justify them.

5.4 SPECIFIC INVESTIGATIONS

Investigation on behalf of a person proposing to buy a business

- **Objectives.** An investigation on behalf of the prospective buyer of a business generally has any one or more of the following object:

(a) To determine the most advantageous basis of exchange and the items to be exchanged i.e, gross assets, net assets, fixed assets, and share capital.

b) Computation of the price to be paid. In some cases, the price may be fixed with in broad limits, with the auditor being only required to determine the exact sum. In others, the price computed by the auditor may serve as the basis for the start of the negotiation.

c) Form of Transfer. This may be by way of amalgamation, with the business being completely taken over, or acquisition of only a part of the business, such that the business is left intact with its identity as also certain assets and liabilities. In certain cases, only controlling interest in the business may be acquired through a quiet purchase of its shares.

- **Mode of investigation.** The client would quite naturally want to have as much information as possible in regard to the business. It is there fore, the duty of the auditor to collect the necessary data, covering the financial and accounting matters as also other aspects of business.

Accordingly the auditor must assemble and evaluate the following information carefully:

- General particulars of the business:

(a) Date of information

(b) Names of promoters

(c) Predecessors

(d) Principal markets

(e) Types of customers

(f) Distribution network

- Number of plants and their location
- Number of sales centers and their location
- List of share holders
- Names of directors and other executives
- Credit reports
- Area of business:

(a) Effect of population

(b) Existing earning potential

(c) Future prospects for growth

(d) Competing units

(e) Prospects of industry

- Manufacturing position:

(a) Sources of supply of raw materials

(b) Sources of supply of labour

- Organisation Structure:

(c) Qualifications, experience and potential of directors

(d) Qualifications, experience and potential of executives

(e) Salaries payable to executives

- Financial Position:

(a) Latest financial statements

(b) Summaries of financial statements of the past 5-10 years

(c) Found-flow statements

(d) Ratio analysis

- Tax Liability:

(a) Central taxation

(b) State and local taxation

(c) Projected tax liability.

- Assets:
- Cash:

(a) Types of bank accounts and their purpose
(b) Accounting procedures
(c) Internal control
(d) Cash requirements and availability

- Book debts

(a) Analytical summary of book debts
(b) Overdue accounts duly classified
(c) Internal control policies as regards credit and discounts
(d) List of major customers and their credit worthiness
(e) Amounts receivable and extent of their collectibility
(f) Reserves for bad debts, discounts, etc.

- Stock- in-trade:

(a) Types of stock-in –trade
(b) Last date of stock taking and adjustments
(c) Method for pricing stores
(d) Internal control
(e) Present purchase commitments
(f) Present sales commitments and position of available stocks to meet them in time.
(g) Value of obsolete items
(h) Comparison of stock turn over with the average for the industry
(i) Market value of stock- in-trade.

- Investments:

(a) Analytical summary of investments
(b) List of significant investments
(c) Cost and market value of investments
(d) Existence of investments
(e) Investments in own subsidiaries.

- Fixed assets:

(a) Summary of the types of assets
(b) Date and cost of acquisition
(c) Purpose and location

(d) Total depreciation – asset wise

(e) Market value

(f) Insurance coverage

(g) Discarded or obsolete items not written off

(h) Custody of items and maintenance of records

(i) Lease-hold property, with dates of expiry, renewal, rent payment, etc.

(j) Commitments as regards capital expenditure

(k) Condition of assets

(l) Mortgages

- Pre-payments:

(a) Summery of pre-payments and their genuineness

(b) Method of recordings pre-payments.

- Liabilities:

(a) Trade creditors

(b) Analytical summary of trade creditors balances

(c) Confirmatory letters as regards balances from creditors

(d) List of significant accounts

(e) Reasons for large balances

(f) Ratio of creditors balances and current assets

(g) Existence of any charge as regards balances

(h) Dates of accrual of liabilities against acceptances.

- Loans:

(a) Amount of loans, whether secured or other wise, including liability as regards interest and penalty for default in payments.

(b) Overdrafts

- Contingent liabilities as regards guarantees, warrantees, etc.,
- Losses:

(a) Current losses

(b) Losses carried forward from past years

- Long –term debts:

(a) Summary of long-term debts

(b) Terms, at which the debts have been secured, including liability as regards payment of interest.

(c) Mortgages and charges

(d) Confirmation of balances from individual creditors

- Capital:

(a) Number and classes of shares issued and un issued

(b) Provision, if any, for unpaid dividend on cumulative preference shares

(c) Undistributed profits and their capitalization in to reserve, etc.

(d) Dividend policies.

- **Review Procedure.** If the books of account of the business have been properly maintained and audited, the auditor will have little difficulty in assembling the required data. Where it is not so, he will have to be more careful and in some cases he may have to redraft the Trading and Profit and Loss Account and the Balance Sheet on a consistent basis so as to make for easy comparison.

While reviewing the data, the following points should be borne in mind:

- The sales figures fir different years and months should be carefully compared and any abnormal fluctuations should be thoroughly enquired into.
- In the Trading Account, the percentages of different expenses to gross sales should be checked and any significant variations should be probed.
- The stock sheets for each year should be examined with particular reference to treatment of obsolete and discarded items, goods sent on consignment or approval basis, and goods sold though not actually supplied.
- The amount of gross profits for different years should be compared. Profits of the last few years should be more carefully checked to ascertain whether these have been unduly inflated by means of overstating of sales or stocks at hand or by understanding expenses, to exhibit an attractive picture of the earning potential of the business intended to be sold.
- The account of significant customers should be checked to see whether there is anything unusual in the purchases made by them in recent months.
- Net profits disclosed by Profit and Loss account of different years should be carefully checked to note any material differences. Further, the amount of profits should be adjusted as follows:

Increase the profits by-

(a) Interest on capital and current account balance as also salaries, commission, bonus, etc., paid to partners;

(b) Interest on loans which are not proposed to be taken over;

(c) Interest on overdrafts which the prospective buyer would not pay due to adequacy of working capital;

(d) Any exceptional losses arising due to lack of adequate insurance cover;

(e) Expenses of capital nature charged to Profit and Loss Account; and

(f) Excessive provision for bad and doubtful debts.

Decrease the amount of profits by –

(a) Income from assets not being taken over;

(b) Capital profits;

(c) Exceptional profit, such as from speculation;

(d) Adequate depreciation in case this has not been provided; and

(e) Such other expenses which deserve to be provided

- Variations in the number and value of assets should be carefully noted. Adequacy of depreciation should be properly evaluated.
- Good will of the business should be valued as per any of the recognized methods, e.g., average profits, super profit, capitalization.
- In case any professional or technical staff is likely to leave in the future, its effect on the business operations should be carefully evaluated.
- Service agreements with the staff examined as also whether the staff are adequately motivated.

5.4.1 Investigation in the case of admission of a new partner

An investigation in such a case may be undertaken either on behalf of the person who indents to join a partnership, or on behalf of the partners proposing to induct a new partner.

Incase the investigation is on behalf of incoming partner, the auditor is under an obligation to provide him with as much information as possible regarding the financial and other aspects of the firm. In many respects, his investigation would proceed along the same lines as incase of acquisition of a new business but he should pay particular attention to the following points:

- He should secure a draft copy of the proposed partnership agreement and study it carefully to see that it contains nothing that is detrimental to the interests of the client.
- He should examine the values at which various assets and liabilities are proposed to be brought in the book of new partnership.

- He should ascertain whether adequate provision has been made for book debts of the doubtful nature, as also contingent liabilities pertaining to the period prior to his admission.
- He should see that the valuation of goodwill as also the amount determined to be brought in by his client is just and reasonable, considering the potential of the business.
- He should investigate the reasons why the business needs induction of a new partner, e.g., paucity of capital or managerial know how, and enlighten his client on this score.
- He should see that the firm has wholly cleared or made adequate provision for clearing income tax and other tax liability up to the date of reconstitution of the firm.
- He should see if any of the existing partners is likely to retire in the near future and examine its effects on the business.

In the case of an investigation on the behalf of the existing partners proposing to induct a new partner, the auditor should ascertain:

(a) The financial standing of the incoming partner;

(b) His past/present business connections;

(c) Reasons why he withdrew from any firm; and

(d) His business acumen, honesty, and integrity.

5.4.2 Investigation on behalf of bank, etc, as regards proposed grant of loans

Before extending a loan or overdraft facility to a customer, the bank would naturally want to be assured as to his sound financial position to meet interest and repayment obligations. In most cases, all that the bank examines for this purpose is the latest Balance sheet of the customer so as to satisfy itself as regards adequacy of valuable assets owned by the customer and reasonably adequate earnings.

5.4.3 In the case of loan for a new project:

In some cases particularly in the case of loans involving sizable sums to finance new or on-going projects of the customer, the bank may call for a detailed investigation by an auditor before making up its mind on extending the facility. The points deserving of special attention in the case of such investigations are as follows:

- The gestation period., i.e ., the time to be taken for the project to start commercial production and financially viable.
- The activity schedule, i.e., the maximum time during which different phases of the project would be completed.
- Estimated cost of the project, including the cost of each item involved therein.

- Estimated profit earning potential as worked out by the accounting ratios.
- Estimated liability as regards taxes, dividends, managerial expenses, interest on borrowings, etc.
- Working capital
- Adequacy of security offered.

5.4.4 In case of an on-going concern:

Where a loan is proposed to be made to an on-going business, the auditor should prepare an analytical summary of the current and other assets of the business, including their cost and market value as also encumbrances, if any, created in respect there of. He should, *inter alia*, closely examine the following:

- Book debts with reference to the period of credit extended.
- Amounts due from directors, partners, employees, branches, subsidiaries, etc.
- Adequacy of provision for bad and doubtful debts.
- Existence of charge in respect of any of the amounts against any loan.
- Valuation as per a generally accepted and consistently followed method of valuation of Stock-in-trade, including finished goods, working progress, raw materials, etc.
- Cost and Market value of fixed assets such as buildings, plant, machinery and other fixtures, the adequacy of depreciation provided including creation of any mortgage or charge thereon.
- Cost and Market value of investments, including provision for fluctuation in prices and creation of any pledge in respect thereof.
- Long-term liabilities, including the amounts involved, interest payable repayment schedule, Mortgages and charges involved, etc.

While making the report, the auditor should not lose sight of any existing or contingent liabilities such as guarantees, warranties, present commitments, etc. He should also state whether there are sufficient grounds for seeking the loan, and whether the amount of loan is going to be profitable employed business so as to meet interest and repayment obligations.

5.4.5 Investigation as regards determination of tax liability

Investigation with regard to determination of actual tax liability will undertaken where the client is of the opinion that his income chargeable to tax has not been computed properly or relief’s available under the law have not been correctly availed, or deduction as regards various expenses, including depreciation, has not been correctly claimed, or the amount of tax has not been computed correctly.

While undertaking such an investigation, the auditor should examine depth all relevant books of account and records to ascertain as to which transactions have escaped record for tax purposes. Correctness of entries and totals should also be verified by means of ratio analysis.

In any case the client has not maintained proper books of account, that expenditure figures should be reconciled with of disclosed incomes and any inconsistency between the two should be deeply probed.

In any case, in his investigation report the auditor must clearly state the inadequacies in the data and information complied by him and the extent of his own responsibility for accuracy of such data and information, IN Hedley Bynt & Co, v. Heller and Partners Ltd. (1963), it was held that the auditor would be liable if, by reason of his negligence in preparing reports, accounts for finance statements, any loss is suffered by any party, including a third party, including a third party with whom the auditor has no privacy of contract, and the loss is suffered in circumstances financial where the auditor knew, or ought to have known, that his reports or accounts or financial statements were being prepared for a specific purpose or transaction which gave rise to the loss, and that these would be shown and relied upon in that particular connection.

5.4.6 Investigation as regards fraud or negligence:

An investigation as regards a fraud or negligence, whether real or suspected, will be conducted in terms of the instruction from the client.

The methods by which fraud may be committed are beyond enumeration, and only by the perpetrator’s sense of imagination and the opportunities available to him to put his plans in to action, However, by far the most vulnerable areas are cash disbursements and receipts, investigation and securities, though there are instances where even fixed assets have not been spared.

Where fraud concerns a single area such as lapping of the receipts, or payments to fictitious workers, the scope of the investigation will be limited. On the other hand, if it pervades more areas involving collusion between various employees holding responsible positions, the investigation would inevitably cover wide ground.

Misappropriation of Cash: In case the alleged fraud involves misappropriation of cash, the auditor should proceed as follows.

- Internal control as regards cash receipts and payments should be carefully examined to ascertain its weak points.
- Employees involved in receipt and payment of cash should be closely mentioned to secure all necessary information as regards the possible ways in which fraud may be committed. Internal auditors of the client may provide valuable clues in this respect.
- The Rough cash book should be tallied with the Cash Book and bank paying in slips
- Entries in Cash Book should be vouched with money receipts.

- Confirmation as regards payments and account balances should be independently obtained from the customers and disagreements, if any, should be closely examined.
- Payments should be checked with the Cash Book, counterfoils of the cheques issued, and the Bank Pass Book. Authorization for individual payments should be carefully checked.
- Payments to employees, partners or directors should be confirmed.
- Cash balances should be verified at a single sitting and certificates as regards bank balances should be obtained from the banks direct, and reconciled with the Cash Book.

Fraud as regards wage payments:

- Internal control system as to wage payments should be closely examined for any possible weak points.
- Entries in the wage sheets should be checked with the Original documents, such as appointment letters, time and piece wage records, wages rates, etc.
- Individual workers should be identified on the basis of particular as regards names and card numbers, so as to detect any addition of dummy workers in the wage sheets.
- All deductions from wages such as provident fund contributions, insurance premia, etc., should be checked to detect forged totals and deliberate errors.
- The system as regards unclaimed wages and their custody and record should be carefully checked.

Manipulation of inventory:

- The system of internal control should be carefully checked to ascertain its weaknesses.
- Entries in the Stock Register should be carefully vouched with the relevant records, such as, Sales and Purchases Day Books, invoices, money receipts, etc.
- Stocks down to be with outstation branches should be physically verified.
- Valuation of stock-in –trade is a field which manipulations are the most likely, particularly by those who are at the higher levels of management. Special attention should be given to the method of valuation and the pricing should be independently confirmed from the outside sources, e.g., market reports, trade associations, etc.

Legal Hurdles: The auditor, who has been engaged to investigate a fraud allegedly committed by employees of the client, must safeguard his position against possible legal action for defamation, false arrest, imprisonment, etc. During the course of the investigation, he should regularly seek advice from his counsel.

In any case, his investigation should be meticulously planned and executed; taking extreme care at all times to record all facts, amounts, dates, time, and their critical information. He must preserve all original evidence and his own working papers concerning the investigation. It should be remembered that he is an auditor, not an advocate, and hence has no right to accuse an employee or publicise his involvement in any fraud. Also he should not be party to any secret deal between his client and an employee to the effect that the employee will not be persecuted even if his involvement is proved beyond doubt.

5.5 SPECIAL AUDIT

Sec. 233-A deals with the powers of the Central Government to direct special audit in the case of a company subject to certain conditions.

When special audit may be ordered

Where the Central Government is of opinion-

(a) That the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or

(b) That any company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(c) That the financial position of any company is such as to endanger its solvency. It may at any time, by order, direct that a special audit of the company's accounts for the period as specified in the order, shall be conducted.

Appointment of a special auditor

The auditor for a special audit is to be appointed by the Central Government. The person to be appointed a special audit must be a chartered accountant with in the meaning of Chartered Accounted Act, though it is not necessary that he should also be in practice. The company's own auditor may also be appointed by the Central Government to conduct special audit.

Remuneration

All expenses concerning the special audit, including the special auditor's remuneration, shall be determined by the Central Government and paid by the company. Determination of such expenses by the Central Government shall be final.

Powers and Duties

The special auditor shall have the same powers and duties as the auditor of a company under sec.227. But he will, instead of making the report to the members of the company, make the same to the Central Government.

Directions to the Central Government

The Central Government may, by order, direct any person to furnish to the special auditor, with in the period specified, such information or additional information, as may be required by the special auditor in connection with his special audit.

Report

The report of the special auditor shall, as far as may be, include all the matters required to be included in an auditor's report under sec.227and, if the Central Government so directs, shall also include a statement on any other matter which may be referred to him by that Government.

5.6 STATUTORY INVESTIGATION

Secs.235 to 251 of the Companies Act deal with investigation of the affairs of a company to be made by the Central Government –

(a) On a report made by the Registrar under Sec.234(6) or(7);

(b) On an application by the members of the company; and

(c) In any other case, such as on special resolution of the company; or on an order of the Court.

On report by the Registrar (Sec. 235(1)):

As per Sec.235(1), as recast by the Companies (Amendment) Act 1988, the Central Government may, upon a report by the Registrar under Sec.234(6) or (7), appoint one or more competent persons as inspectors to investigate the affairs of a company and to report thereon in such manner as it may direct.

Sec.234(1) of the Companies Act empowers the registrar to call for any information or explanations as regards any matter concerning any documents required to be submitted by the company. It is the duty of the company to provide such information or explanation with in the time specified by the Registrar.

According to Sec. 234(6), if such information or explanation is not furnished by the company with in the specified time, or if the company has furnished the required information or explanation but the Registrar is of option that such information etc., read together with the document to which it relates, discloses an unsatisfactory state of affairs or does not disclose a full and fair statement of the matter referred to in the said document, the Registrar shall report the circumstance of the case to the Central government. Thereupon, as stated in the first paragraph, the central Government may order investigation of the affairs of the company.

According to Sec. 234(7), if it is represented to the Registrar by any contributory, or creditor, or any other person that the business of a company is being carried on in fraud of

its creditors, or of persons dealing with the company or otherwise for a fraudulent or unlawful purpose, he may require the company to furnish any information or explanation on matters specified in the order. However, before making such order, the company will have to be given an opportunity of being heard.

The Registrar may call for information etc. only in respect of the documents required to be submitted by the company, and not in respect of any other document. But then, almost every matter about a company may be covered under one or the other document. As for information which is sought as a consequence of any representation, it is necessary that the person representing to the Registrar must be a person interested in the company, and not a stranger. Moreover, the fraud alleged in the representation should be a present or continuing fraud and not a past fraud.

On application by members of the company [Secs. 235(2)(a),(b) and 236]

The Company Law Board may appoint one or more competent persons as inspectors to investigate the affairs of a company, and to report thereon in such manner as the Central Government may direct –

a) In the case of company having share capital, on an application of not less that 200 members, or the members holding not less than one-tenth of the total voting power;

b) In the case of a company not having share capital, on an application of not less than one-fifth in number of the persons on the company's Register of Members.

The expression "not less than 200 members" or "members holding not less than one-tenth of the total voting power means that any such members, whether holding equity or preference shares, are competent to make the application for investigation.

The expression "total voting power" as defined in Sec.2(48) means the total number of votes which may be cast on pole at a meeting of the body corporate if all the members there of, and all other persons entitled to vote therein, are present at the meeting and cast their votes.

The application by members of the company must be supported by such evidence as the Central Government may require for the purpose showing that the applicants have good reason for requiring the investigation. The Central Government may also, before appointing an inspector, require the applicants to provide a security up to Rs.1, 000 for payment of the costs of investigation.

The order regarding investigation (on an application by the members of the company), is purely discretionary on the part of the Central Government and there can be no interference by the Court with the exercise of such discretion.

Investigation in other cases [Sec. 237]

Sec. 237 requires the Central Government to appoint inspectors to investigate the affairs of a company and to report there on as directed. The powers conferred by this Sec are with out prejudice to the powers under Sec. 235 requiring the Central Government to order investigation on application by the members, or on report by the Registrar. Moreover,

investigation in the case of circumstances specified in Sec. 237(a) is mandatory, while in regard to circumstances specified in Sec. 237(b), it is discretionary.

- **Where investigation is Mandatory [Sec 237(a)].** The Central Government shall appoint one or more competent persons as inspectors to investigate the affairs of a company if –

a) the company, by a special resolution, or

b) the Court, by an order declares that the affairs of the company ought to be investigated by an inspector appointed by the Central Government.

The shareholders, by a special resolution, can exercise their right to know the state of affairs of the company in whosoever in hands they may be. There is no mention here of the circumstances under which the Court may order investigation in the affairs of a company, or of the persons who may seek such order from the Court. However the "Court" in this case means the Court having jurisdiction under Sec. 10 of the Companies Act.

The expression "the affairs of a company" is wide enough to include all its business affairs, interests or transactions, all its investments or other property interests, all its profits and losses, or balances of profits or losses, and its good will [Regina v. Board of Trade(1965) 1 Q.B. 603]. It also includes the affairs of the company in the hands of a receiver or manager appointed by the court or any other person, and not merely its affairs under the control and the management of the Board of directors.

- **Where investigation is discretionary [Sec. 237(b)].** The Central Government may appoint one or more competent persons as inspectors to investigate the affairs of a company if in the opinion of the company law board, there are circumstances suggesting –

a) That the business of the company is being conducted –

i. With intent to defraud its creditors, or members, or any other persons;

ii. For a fraudulent or an unlawful purpose, or in a manner oppressive of any of its members; or

b) that the company was formed for any fraudulent purpose or an unlawful purpose;

c) tat the persons concerned in the formation f the company, or the management of its affairs, have been guilty or fraud, misfeasance or other misconduct towards the company or towards any of its members; or

d) that the members of the company have not been given all the information with respect to its affairs which they might reasonably expect, including information relating to calculation of the commission payable to a managing director or other director, or manager of the company.

Under Sec. 237(b), the Central Government may on its own initiative, or on an application or information provided by any share holder, order investigation in the affairs of the company, provided any of the conditions mentioned above exist. If it can be shown that the circumstances do not exist, or that they are such that it is impossible for any one to form an opinion suggestive of the aforesaid things, the opinion is challengeable on the ground of non-application of mind or perversity, or on the ground that it was formed on collateral grounds and was beyond the scope of the law.

Inspector [Sec 238]

Only an individual can be appointed as inspector to conduct an investigation. As said in Ashoka Marketing Ltd. V. Union of India (Air 1967 Cal. 159), the inspector's function is equivalent to the function of a fact-finding mission.

Powers of inspectors [Sec. 239]

- **To investigate affairs of any other company in same group**

  If the inspector appointed to investigate the affairs of a company considers it necessary for the purposes of his work, also to investigate the affairs of any other body corporate, which is at relevant time under the same management or group, he has the power to do so and to report on the affair of that other body corporate to the extent it is relevant for the investigation of the first company.

  However, in certain cases, prior approval of the Central Government is required for overstepping the brief [Sahu Jain Ltd. V. union of India (1965) 2 Comp. L.J. 145]. More over, before according such approval, the Central Government shall allow the body corporate a reasonable opportunity to show cause why such approval should not be accorded [Sec. 239(2)]

- **To require officers of the company to produce books, etc., and to assist**

  It is the duty of all officers and agents of the company to preserve and produce to the inspector all books and papers of, and relating to, the company which are in their custody or power. They are also duty-bound to give to the inspector all assistance in connection with the investigation which they are reasonably able to give [Sec. 240(1)].

- **To require any body corporate to give information**

  The inspector may, with the prior approval of the Central Government, require any body corporate to furnish such information, or to produce to him such books and papers, as he may consider necessary or relevant for the purpose of his investigation [Sec. 240(1-A)].

- **To keep books and papers in custody**

  The inspector may keep in his custody any books and papers produced before him for six months, but there after he is bound to return the same to the person by whom or on whose behalf the books and papers were produced.

If any person fails with out reasonable cause, or refuses –

a) To produce to the inspector, or any person authorized by him in this behalf, any books or papers which it is his duty to produce; or

b) To furnish any information which it is his duty to furnish; or

c) To appear before the inspector personally when required to do so to answer any question which is put to him by the inspector; or

d) To sign the notes of any examination,

He shall be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to Rs. 2,000 or with both, and also with a further fine which may extend to Rs. 200 for every day after the first during which the failure or refusal continuous [Sec. 240(3)].

- **To examine officers on oath**
  The inspector may examine on oath any officers and employees of the company. With the previous approval of the Central government, he may also examine any other person and require any of these persons to appear before him personally [Sec. 240(2)]
  Notes of any examination must be taken in writing and must be read over to, or by, and signed by the person examined, and they may be there after be used in evidence against him.

- **To seize books and papers**
  If, in the course of the investigation, the inspector has reasonable ground to believe that the books and papers of the company may be destroyed, mutilated, altered, falsified, or secreted, and then he may, with the permission of the magistrate of the First Class or Presidency Magistrate, seize the books and papers [Sec. 240A(1)]. The magistrate may also by order authorize the inspector –

a) to enter, with such assistance as may be required, the place or places where such books and papers are kept;

b) to search that place or those places in the manner specified in the order; and

c) to seize books and papers which he considers necessary for the purpose of his investigation [Sec. 240A(2)]

The books and papers so seized shall be kept in the inspector's custody for such period, not later than the conclusion of the investigation, as he considers necessary. There after, he shall return the same to the company or any other person from whose custody or power these were seized and inform the Magistrate of such return.

Inspector's report [Sec. 241]

The inspector may and, if so directed by the Central Government must, make interim report to the Government. On the conclusion of investigation, he must make a final report to the Central Government. The report shall be in writing or printed, as the central government shall direct.

There is no stipulation as regards the time for making of the report. The order of investigation, however does make a mention of the time with in which the report is to be made. However, failure to submit the report with in the stipulated time only amounts to breach of duty on the part of the inspector, and it will not automatically bring the investigation to the end [Ashoka Marketing Ltd. V Union of India AIR (1967) Cal.159].

Manner of disposal of report by Central Government [sec. 241(2)]

The Central Government—

a) shall forward a copy of the report made by the inspector to the company as its registered office and also to any body corporate dealt with in the report;
b) may, if it thinks fit, furnish a copy there of, on request and on payment of the prescribed fee, to any person being a member, creditor, etc. of the company;
c) shall, in the case of appointment of the inspector on the application of the members under sec. 235, furnish at the request of the applicants for such investigation, a copy of the report to them;
d) shall, in the case of appointment of the inspector under Sec. 237 in pursuance of an order of the court, furnish a copy of the report to the Court;
e) shall, where the inspectors are appointed under Sec. 235, furnish a copy of the report to the Company Law Board; and
f) may also cause the report to be published.

Prosecution (Sec. 242)

If, from any report under Sec. 241, it appears to the Central Government that any person has, in relation to the company or in relation to any other body corporate whose affairs have been investigated, been guilty of any offence for which he is criminally liable, Central Government may prosecute such person for the offence. In such a case, it is duty of all officers and other employees and agents of the company, and the body corporate (other than the accused in the proceedings) to give to the Central Government all reasonable assistance in connection with the prosecution.

Application to Court for winding up of company (Sec. 243)

On the basis of the inspector's report, the Central Government may apply to the court for winding up of the company on the ground that such winding up would be just and

equitable, and also make an application for an order for prevention of oppression or mismanagement under Sec. 397 or 398.

Expenses of investigation (Sec. 245)

The expenses of any investigation by an inspector appointed by the Central Government are to be defrayed in the first instance by the Central Government. But the following persons are also liable to reimburse the expenses to the Central Government to the extent mentioned:

(j) Any person who is convicted on prosecution instituted in pursuance of the report of the inspector, or who is ordered to pay damages to restore any property as a result of the report, may be ordered to pay the said expenses to the extent specified by the court.

(k) Any company or body corporate, in whose name in the proceedings are brought, is liable to the extent of the amount, or the value of any sums or property, recovered by it as a result of the proceedings. Any amounts for a which a company or body corporate is liable will be the first charge on the sums or property recovered by the company as a result of the proceedings.

(l) Any Company, body corporate, managing director, or manager dealt with by the report, and the applicant are to be liable to such extent as the Central Government may direct.

Investigation of ownership of company (Sec. 247)

Under Sec. 247, if it appears to the Central Government that there is good reason to do so, it may appoint one or more inspectors to investigate and report on the membership of the company and other matters relating to the company, for the purpose of determining the persons—

a) Who are, or have been, financially interested in the success or failure, whether real or apparent, of the company; or

b) Who are or have been able to control or materially influence the policies of the company.

The powers of the inspector in any such case as regards production and seizure of documents are the same as under Sec. 235. More over, these powers extend even to cover persons whom the inspector believes to be covered by the provisions of (a) or (b) above.

After the conclusion of the investigation, the inspector is required to submit a report to the Central Government, though the Central Government on its part is not obliged to furnish a copy of the report to the company or to any other person, if it is of opinion that there is good reason for not divulging the contents of the report.

According to Sec. 235(1A), inserted by the Companies (Amendment) Act 1988, the Central Government shall also appoint one or more inspectors under sec. 235(1) if the

Company Law Board, in the course of any proceedings before it, declares that the company ought to be investigated as regards its membership and other matters relating to it, so as to determine the true persons—

a) Who are or have been financially interested in the success or failure, whether real or apparent, of the company; or

b) Who are or have been able to control or materially to influence the policies of the company.

The expenses of any investigation are to be defrayed by the Central Government, though it may direct that any part of such expenses be paid by the persons on whose application the investigation was ordered.

5.7 ELECTRONIC AUDITING

5.7.1 Introduction

Electronic auditing is the same as computer-assisted auditing where electronic records are used to complete all or part of the audit. This manual will list the benefits of performing electronic audits, cite the legal authority for electronic auditing, explain steps to ensure confidentiality, identify electronic audit candidates, explain the process of obtaining, converting and testing taxpayer data (along with several sample letters and forms), review the three electronic audit techniques and when they should be used, identify the additional considerations for a stratified statistical sample, refer you to the e-auditing website, and review the documentation required for an electronic audit case file.

5.7.2 Benefits

The decision of whether the Department can pursue an electronic audit instead of a hard copy audit is based on the nature of the taxpayers' records. Electronic audits generally reduce the collective effort needed by the taxpayer and the Department to complete the audit. In many instances detail audit procedures can be performed using the electronic data in the same amount of time as it takes to perform a sample, making the audit results more accurate. In addition, stratified statistical sampling can be performed on electronic records. Stratified statistical sampling allows for measurement of audit risk and is therefore more defensible in court.

5.7.3 Legal Authority

Every audit has the potential of being an electronic audit. If any electronic data is available in any form, it may be used. Section 213.35, Florida Statutes (F.S.), states:

"Each person required by law to perform any act in the administration of any tax enumerated in s. 72.011 shall keep suitable books and records relating to that tax, such as invoices, bills of lading, and other pertinent records and papers, and shall preserve such

books and records until expiration of the time within which the department may make an assessment with respect to that tax pursuant to s. 95.091(3).”

Part II of Rule Chapter 12-24, Florida Administrative Code (F.A.C.), addresses a taxpayer’s recordkeeping and retention responsibilities. This rule chapter describes the requirements when “all or a part of the taxpayer’s records are received, created, maintained or generated through computer, electronic, and imaging processes and systems.”

Rule 12-24.023, F.A.C., states, in part: “(2) If a taxpayer maintains records required to be retained under this chapter in both machine-sensible and hardcopy formats, the taxpayer shall make the records available to the Department in machine-sensible format upon request of the Department.” Rule 12-24.026, F.A.C., addresses a taxpayer’s responsibilities concerning Department access to machine-sensible records.

Rule 12-24.026, F.A.C., provides: “(1) The manner in which the Department is provided access to machine-sensible records as required in subsection 12-24.023(2),

F.A.C., may be satisfied through a variety of means that shall take into account a taxpayer's specific facts and circumstances, as determined through consultation with the taxpayer.

(2) Departmental access will be provided in one or more of the following manners:

(a) The taxpayer may arrange to provide the Department with the hardware, software and personnel resources to access the machine-sensible records;

(b) The taxpayer may arrange for a third party to provide the hardware, software and personnel resources necessary to access the machine-sensible records;

(c) The taxpayer may convert the machine-sensible records to a standard record format specified by the Department, including copies of files, on a magnetic medium that is agreed to by the Department; or,

(d) The taxpayer and the Department may agree on other means of providing access to the machine-sensible records.”

5.7.4 Confidentiality of Data

The confidentiality of all tax information is required by Section 213.053, F.S. Electronic data is considered confidential information. Any violation of confidentiality is considered a misdemeanor of the first degree and punishable under Sections 775.082 or 775.083, F.S. As noted, the Florida Statutes guarantee confidentiality of taxpayer data. If a taxpayer is concerned about the confidentiality of their data when sending by common carrier or the U.S. Mail, they may send their data with no return address and a unique identifying number on the CD or tape. In addition, the file layout can be sent Basic Electronic Auditing Manual GT-400514, separately from the data. This procedure will maintain taxpayer anonymity in the unlikely event that you do not receive the data. If the data

requires conversion by Applied Technology, you may follow these same steps when sending the data and file layout to Applied Technology. This arrangement may not be necessary for all taxpayers, but is available when needed.

5.7.5 Electronic Audit Candidates

Candidates for electronic audits include taxpayers that use a computer for recording their business activity and that maintain this data in machine-readable format. As such, many taxpayers are candidates for an electronic audit. When the Notice of Intent to Conduct an Audit (form DR-840) is mailed to the taxpayer, the following documents should also be mailed:

• Cover Letter

• Electronic Audit Survey

• Electronic Audit and Stratified Statistical Sampling Brochure (Form GT-800050)

• Taxpayer's Bill of Rights Brochure

After the survey is returned, you will need to determine whether or not an electronic audit should be pursued. If it is determined that electronic auditing techniques will be used, the taxpayer is contacted to request the data in the appropriate format. It is not necessary to have electronic data for all areas to be audited (sales, purchases, fixed assets, leases, etc.) If electronic data is available only for purchases, and not for sales, this taxpayer can still be considered a candidate for electronic auditing of purchases.

All taxpayer data should be requested for the audit period, including sales, fixed asset purchases, expense purchases, and rental transactions, along with any other data that is necessary to properly conduct the audit. Electronic data interchange (edi) taxpayers.

The computer-to-computer exchange of business transactions is known as EDI (Electronic Data Interchange). For taxpayers who operate in an EDI environment, there will be very little, if any, hard copy records available for examination since this is a paperless environment. These types of taxpayers can only be audited using electronic audit techniques. As noted previously, Part II of Rule Chapter 12-24, F.A.C., addresses a taxpayer's recordkeeping responsibilities. Rule 12-24.024, F.A.C., states, in part:

2) Electronic Data Interchange Requirements: (a) "Where a taxpayer uses electronic data interchange processes and technology, the level of record detail, in combination with other records related to the transactions, must be equivalent to that contained in an acceptable paper record. For example, the retained records should contain information including vendor name, invoice date, product description, quantity purchased, price, amount of tax, indication of tax status, and shipping detail. Codes may be used to identify some or all of the data elements, provided that the taxpayer provides a method which allows the Department to interpret the coded information.

(b) The taxpayer may capture the information necessary to satisfy these rules at any level within the accounting system and need not retain the original EDI transaction records provided the audit trail, authenticity, and integrity of the retained records can be established. For example, a taxpayer using electronic data interchange technology receives electronic invoices from its suppliers. The taxpayer decides to retain the invoice data from completed and verified EDI transactions in its accounts payable system rather than to retain the EDI transactions themselves. Since neither the EDI transaction nor the accounts payable system captures information from the invoice pertaining to product description and vendor name (i.e., they contain only codes for that information), the taxpayer must retain other records, such as his or her vendor master file and product code description lists and make them available to the Department. In this example, the taxpayer need not retain its EDI transaction for tax purposes.

(3) **Electronic Data Processing Systems Requirements**. The requirements for an electronic data processing accounting system should be similar to those of a manual accounting system, in that an adequately designed accounting system should incorporate methods and records that will satisfy the requirements of this chapter."

Acceptable data FORMAT and supported media If a taxpayer uses a mainframe computer system, a flat file (non relational) should be requested. The format of the files can be EBCDIC, ASCII, Comma Delimited, Tab Delimited, or Space Delimited.

Review Questions:

1. Define investigations and explain its objectives
2. Distinguish between auditing and investigation.
3. What are the types of investigation?
4. Write a note on investigation under the Companies Act.
5. Explain about Electronic Audit and its benefits.
6. What is the Legal authority for the Electronic audit?
7. Explain the Special Audit.

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Model Question Paper - 1

AUDITING

Time: 3 Hrs | Max Marks: 100

Answer any FIVE Questions (5*20=100)

1. Define auditing. And how it is different from accounting? State the general objects of Auditing?
2. Discuss the advantages and limitations of auditing.
3. Explain the kinds of vouchers
4. Define verification of assets and its importance with example
5. Describe the Qualities of an auditor.
6. Define audit report. Explain its contents?
7. What are the types of investigation?
8. Explain about Electronic Audit and its benefits.

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Model Question Paper - 2

Auditing

Time: 3 Hrs Max Marks: 100

Answer any FIVE Questions (5*20=100)

1. Explain the evaluation of auditing.
2. Describe the Qualities of an auditor.
3. Elaborate the Depreciation audit with its various types.
4. Explain the audit of provisions and reserves.
5. Describe the various steps in evaluation of internal control system.
6. “Voucher is the essence of Audit”-Discuss.
7. What are the general principles of verification and valuation of assets?
8. What are the principles of good audit report?