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PRACTICAL AUDITING

STUDY MATERIAL

By

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PREFACE

Auditing is an examination of accounting records and vouchers of a business as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so aas to give a true and fair view of state of affairs of the business and whether the Profit and Loss Account gives a true and fair picture for the financial period according to the information and explanation given to him.

Practical Auditing is an important paper for the commerce students. This study material covers the entire SOEL syllabus for B.Com., LL.B.,(Hons) students. All important concepts have been explained in simple terms and wherever necessary diagrams and flowcharts have been given. Further, Summarized form of advantages and limitations to important concepts has been given to make the students remember and recollect the points easily. All the chapters have been covered in this study material in an understandable manner.

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COURSE OUTLINE

UNIT – I

Meaning and definition of auditing – Distinction between auditing and accounting – objectives – Advantages and limitations of audit – scope of audit – classifications of audits – Audit planning, meaning – Audit programme, meaning, objectives and contents – audit note book, contents, usefulness of audit note book – Audit working papers, meaning. Ownership and custody – Test checking and Routine checking, meaning- Internal control, meaning , definition, objectives, Technique for evaluation of internal control system – Internal check, meaning, objectives, difference between internal control, Internal check and internal audit.

UNIT II

Vouching, meaning and definitions, objectives – Trading transactions – audit of ledger- Scrutinizing of ledgers - vouching of cash receipts and payments. Vouching of outstanding assets and liability – verification, meaning objectives and process – valuation of assets and liabilities- Distinction between verification and valuation.

UNIT III

Depreciation and reserves – meaning – Auditor's duty with regard to depreciation – Reserves and provisions- Distinguish reserves and provision – Depreciation of wasting Assets.

UNIT IV

Appointment of auditors – appointment of first auditor – appointment by central government – filling of casual vacancy – Appointment by special resolution – Re-appointment and compulsory re-appointment – ceiling on the number of Auditorship - Removal of auditor – Remuneration - auditors lien – qualification and disqualification – Duties of the company auditor – Rights and powers of auditors – different classes of auditors – Audit Report – Preparation and Presentation.

UNIT V

EDP audit – meaning -Division of auditing in EDP environment – Impact of computerization on audit approach – online computer system audit – Types of online computer systems – audit around with the computers – procedure of audit under EDP system.

CONTENTS

UNIT – I

1. INTRODUCTION

The word audit is derived from Latin word audire which means 'to hear'. Auditing is a critical examination of the records and books of account of a business by an independent qualified person for ascertaining the authenticity and the accuracy of entries appearing in the books of account and financial statement.

1.1 DEFINITION OF AUDITING

Spicer and Pegler have defined audit as " such an examination of the books , accounts and vouchers of a business as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period , according to the best of his information and explanation given to him and is shown by the books and if not in what respect he is not satisfied."

Montgomery defined auditing as examination of the books and records of a business in order to ascertain or verify and report up on the facts regarding the financial operations and the results thereof."

1.2 ORIGIN AND EVOLUTION

The term audit is derived from the Latin word 'audire', which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them. Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Arthasashthra by Kautilya had emphasized the importance of accounting and auditing.

The original objective of auditing was to detect and prevent errors and frauds. Auditing evolved and grew rapidly after the industrial revolution in the 18th century with the growth of the joint stock companies the ownership and management became separate. The shareholders who were the owners needed a report from an independent expert on the accounts of the company managed by the board of directors who were the employees The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds.

In India, the companies Act 1913 made audit of company accounts compulsory with the increase in the size of the companies and the volume of transactions. The main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts.

The companies Act.1913 also prescribed for the first time the qualification of auditors.The International Accounting Standards Committee and the Accounting Standard board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the accountants and auditors in the day to day work The later developments in auditing pertain to the use of computers in accounting and auditing. In conclusion it can be said that auditing has come a long way from hearing of accounts to taking the help of computers to examine computerized accounts.

1.3 OBJECTIVES OF AUDITING

The objective of an audit may be classified as

(1) Primary Objective

(2) Subsidiary Objective

(3) Specific Objective

1.3.1 Primary Objective or Main Objective:

Expression of expert opinion: - The main objective of auditing is to verify the accounts and records and to report to the owners of the business whether the profit and loss account and the Balance sheet have been properly drawn up according to the requirements of law, and whether they exhibit a true and fair view of the profit and the financial position of the business.

To ensure that the primary objective of audit is achieved, an auditor must:

(a) Examine the Internal Control and Internal Check.

(b) Verify whether all the books of accounts as required by law are kept.

(c) Verify whether proper accounting principles and procedures are followed.

(d) Check the arithmetical accuracy of the books of accounts.

(e) Verify the authenticity and validity of the transactions.

(f) Confirm the existence and the values of the assets and liabilities by physical verification.

(g) Find out whether the financial statement is properly drawn up.

(h) Report whether the profit and loss gives a true and fair view of the profit or loss for the year and Balance sheet gives a true and fair view of the financial position of the business at the end of the financial year.

1.3.2 Subsidiary or Ancillary objectives: - Subsidiary objectives of auditing are

(1) Detection and prevention of errors.

(2) Detection and prevention of frauds.

Detection and prevention of Errors: -

Errors refer to unintentional mis statements in the records or books. Errors are two types namely (1) Clerical or technical errors and (2) Errors of principle.

Clerical Errors: - Clerical errors refer to all types of errors committed on account of clerical mistakes. They are (a) Errors of omission (2) Errors of Commission (3) Compensating errors and (4) Errors of duplication.

Errors of Omission: - An error of omission is one which arises when a transaction has been omitted to be recorded in the books of accounts either wholly or partially. An error of omission may be an error of complete omission or an error of partial omission. An error of complete omission does not affect the agreement of the trial balance, as both the aspects of the transaction are omitted from the trial balance, they cannot be detected easily. They can be detected only by an.intensive checking of the subsidiary books, and the postings from the subsidiary books to the ledger. On the other hand, an error of partial omission affects the agreements of the trial balance, as only one of the aspects of the transactions is omitted from the trial balance, it can be detected easily.

Errors of Commission: - Errors of commission refer to errors committed in the process of posting from the subsidiary books to the ledger accounts, casting, carry forward and balancing of ledger accounts. Some of the errors of commission will not affect the agreement of the trial balance. They cannot be detected easily. Only a thorough checking of the subsidiary books and posting to the ledger can help to detect these errors.

Compensating errors: - When the effect of one error is counter balanced, set off or compensated by another error, the errors are known as compensating errors or offsetting errors. Compensating errors do not affect the agreement of the trial balance, as they are counter balanced or set off.

Errors of Duplication: - Errors of duplication arise when an entry in a book of original entry has been made twice and also been posted twice.

Errors of Principle: - An error of principle arises when the generally accepted principles of accountancy are not observed, while recording a transaction in the books of account. In other words, if a transaction is recorded in the books of account against the generally accepted principles of accountancy, the error is known as an error of principle. Capital expenditure recorded as revenue expenditure or vice versa, capital receipt recorded as revenue receipt or vice versa is examples of errors of principle. Errors of principle will not affect the agreement of the trial balance. Only a detailed and intensive checking will reveal these errors.

Detection and prevention of frauds: - It is intentional or willful representation or deliberate concealment of material fact with a view to deceive, cheat or mislead somebody.

Fraud may be broadly classified into three types. They are

(1) Misappropriation of cash

(2) Misappropriation of goods

(3) Manipulation of accounts

Misappropriation, Defalcation or Embezzlement of Cash: - Misappropriation of cash means the fraudulent appropriation of cash belonging to another person by whom it has been entrusted. Misappropriation of cash may take place in any of the following ways:

(a) Suppression or non disclosure of Cash receipts :

The following are examples of suppression of cash receipts:

(1) By misappropriating the receipt by not recording the same in the Cashbook.

(2) By entering lesser amount on the counterfoil and misappropriating The difference between money actually-received and the amount entered on the counterfoil of the receipt book

(3) By not recording the receipt of sale of a casual nature for example Sale of scrap, sale of old newspapers etc.

(4) By omitting to record cash donations received by non-profit making charitable institutions

(5) By misappropriating the cash received on discounting the bills Receivable and showing them as bills outstanding on hand.

(6) By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, Discount or sales return etc.

(7) By adopting the method of "teeming and lading" or "lapping process". This is one of the methods of misappropriation of cash. Under this method cash received from the first customer is misappropriated by the cashier. The money received from the second customer is credited to the account of the first customer, the money received from the third customer is credited to the account of second customer, and the money received from the fourth customer is credited to the account of third customer and so on. This process is carried out throughout the year.

(8) By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.

(9) By misappropriating the sale proceeds of VPP sales or sales of Goods on approval basis by treating the transaction as goods Received or not approved.

(10) By under casting receipt side total of the cashbook.

(b) Inflating the payments or showing false cash payments: -

The following are examples of this type of misappropriation:

(1) Recording fictitious or false cash purchases and pocketing the amount.

(2) Inflating the cash purchases and pocketing the difference.

(3) Recording payments to fictitious creditors for purchases and pocketing the money.

(4) Recording the payment to creditors at a figure higher than the actual amount and pocketing the difference.

(5) Recording payments to dummy workers and pocketing the money.

(6) Recording fictitious payments of expenses and pocketing the money.

(7) Recording payments of some accounts at figures higher than the actual payments and pocketing the difference.

(8) By showing credit purchases as cash purchases and misappropriating the amount

(9) Recording personal expenses as business expenses

MANIPULATION OF ACCOUNTS

Manipulation of accounts means falsification of accounts without any misappropriation of cash or goods. It implies presentation of accounts more favorably than what they actually are. Manipulation of accounts may be done in any of the following ways:

(1) Non provision of depreciation on fixed assets.

(2) Provision of less depreciation on fixed assets

(3) Provision of more depreciation on fixed assets

(4) Over valuation of assets

(5) Under valuation of assets

(6) Over valuation of liabilities.

(7) Under valuation of liabilities

(8) Recording revenue expenditure as capital expenditure.

(9) Recording capital expenditure as revenue expenditure

(10) Showing expenses of the next year in the current year's profit and loss account

(11) Showing income of the next year in the current year's profit and loss account.

(12) Not recording the accrued expenses in the current year's profit and loss account.

(13) Not recording the accrued incomes in the current year's profit and loss account.

(14) Omission of prepaid expenses.

(15) Omission of incomes received in advance.

(16) Inflating the profits by showing fictitious purchases and sales returns.

(17) Deflating the profits by showing fictitious expenses.

(18) Window dressing: - It is the practice by which the balance sheet is made to show a state of affairs that is different from the actual state of affairs. Generally, the practice of window dressing is adopted to make the balance sheet show a state of affairs far better than the actual state of affairs.

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

(1) Non provision of depreciation on fixed assets.

(2) Provision of less depreciation on fixed assets

(3) Over valuation of assets

(4) Under valuation of liabilities

(5) Recording revenue expenditure as capital expenditure.

(6) Showing income of the next year in the current year's profit and loss account.

(7) Recording of fictitious sales.

(8) Recording fictitious purchase returns

(9) Showing short term liabilities as long term liabilities.

(10) Recording sales of the next year in the current year's revenue account.

1.3.3 SPECIFIC OBJECTIVES

There will be specific objective in respect of each type of specific audits. For example, in operational audit, the aim of audit is to evaluate the existing operations of the entity in order to give expert advice to improve their efficiency. The cost audit is to check the cost records of the entity in order to make a report on the proper ascertainment of cost of production of goods or services. Depending upon the nature of specific audit, there may be different objective in respect of each specific audit.

1.4 PROCEDURE TO BE FOLLOWED TO DETECT ERRORS

Following procedures may be adopted by the auditor to detect the errors.

1. Check the opening balances from the balance sheet of the last year.

2. Check the posting into respective ledger accounts

3. Check the total of the subsidiary books.

4. Verify all the castings and the carry forwards.

5. Ensure that the list of debtors and creditors tally with the ledger accounts.

6. Make sure that all accounts from the ledger are taken into accounts.

7. Verify the total of the trial balance.

8. Compare the various items from the trial balance with that of the previous year.

9. Find out the amount of difference and see whether an item of half or such amount is entered wrongly.

10. Check differences involving round figures as Rs. 1,000; Rs. 100 etc.

11. See where there is misplacement or transposition of figures that is 45 for 54; or 81 for 18 etc.

12. Ultimately careful scrutiny is the only remedy for detection of errors.

1.5 THE AUDITOR'S POSITION AND DUTY IN REGARD TO DETECTION AND PREVENTION OF ERRORS AND FRAUDS

1. Examine all aspects of the finance.

2. Vouch all the receipts from the counterfoils or carbon copies or cash Memos, sales mart reports etc.

3. Check thoroughly the salary and wages register.

4. Verify the methods of valuation of stocks.

5. Check up stock register, goods inwards notes, goods out wards books and delivery challans etc

6. Calculate various ratios in order to detect fraudulent manipulation of accounts

7. Go through the details of unusual items.

8. Probe into the details of the problems when there is a suspicion.

9. Exercise reasonable skill and care while performing the duty.

10. Make surprise visit to check the accounts.

An auditor's position and duty in relation to detection and prevention of errors and frauds had been beautifully explained in the case of Kingston Cotton Mill Company. In this case.it was remarked, "An auditor is a watch dog and not a blood hound".

The remark an auditor is a watch dog limits the audit examination to mere verification of accounts but does not cover detection of errors and frauds. But an effort to detect errors and frauds and suggest ways and means to prevent the errors and frauds in the future. Verification of accounts also implies vigilance on the part of the auditor to detect errors and frauds. As such while verifying the books of accounts, if an auditor smells some irregularities he must follow them h them. Up and unearth them. He should act honestly and takes reasonable skill and care in detecting errors and frauds.

In India, the duty of an auditor has to detect errors and frauds have also been emphasized by the Council of Chartered Accountants. According to this council, an auditor should bear in mind the possibility the existence of fraud or other irregularities, because the financial position may be misstated as a result of errors and frauds.

It is true that an auditor has to detect errors and frauds. But while performing his task of detection of errors and frauds, he need not be a blood hound. He is not required to take to task those staff that has been found guilty of committing errors and frauds. This view was upheld in the case of London Oil Storage Company Ltd VS Seears Hasluck and Company. In this case it was held an auditor is not bound to assume when he comes to do his duty that he is dealing with fraudulent and dishonest people. If circumstances of suspicions arise, it is his duty to probe them to bottom.

To sum up, an auditor is not an insurer against errors and frauds. That he does not guarantee that the books do not contain any errors and frauds.

However, he has always to be very careful about errors and frauds. He must exercise reasonable care and skill in the detection of errors and frauds. Once he suspects the existence of errors and frauds, he must go in to the roots and unearth them. In short, an auditor is not just a watch dog. But, at the same time, he need not be blood hound.

1.6 ADVANTAGES OF AUDIT

Audit offers several advantages. They are:

1.6.1. Advantages of Audit to the business enterprise and Management

(1) Audit ensures the accuracy or correctness of the books of accounts

(2) Audit ensures the authenticity and reliability of the financial statements.

(3) Audit helps in the detection and rectification of errors and frauds.

(4) Audit helps the enterprise and management to ascertain whether the legal requirements are complied with.

(5) Audit point out the weakness of the existing system of internal check and internal control.

(6) Audit examination makes the employees in charge of accounts and records vigilant, regular and up- to –date in their work.

(7) Loans and credit facilities can be easily obtained by a concern on the basis of audited accounts.

(8) Liability of an enterprise as to income tax, wealth tax, and value added tax etc can be easily determined on the basis of audited accounts.

(9) A business can enjoy better reputation, if its accounts are audited by an independent professional auditor.

(10) Audited accounts are more reliable as evidence in courts of law.

(11) Facilitates calculation of purchase consideration.

(12) The insurance claim can be easily determined on the basis of audited accounts.

(13) Audited accounts serve as a basis for solving the disputes as to higher wages.

(14) Comparison of accounts from year to year becomes easier since the accounts are uniformly prepared.

1.6.2 Advantages of audit to the owners of the business:

(1) In the case of a sole trader, auditing assures him that all business transactions have been duly accounted for and there are no errors or frauds. It also helps him to know the true facts about the business.

(2) In the case of partnership firm, audited accounts serve as an evidence of proper management of the affairs of the business. Audited accounts are help in the valuation of goodwill and settlement of accounts on the admission, retirement or death of a partner. Again audited accounts minimize the chances of disputes among the partners.

(3) In the case of a joint stock company, audit of accounts assures the shareholders that the affairs of their company are smoothly and their investment is safe. The shareholders of a company can value their shares on the basis of audited accounts.

(4) In the case of a co – 0p society or a trust, audit assures the members or the beneficiaries that the affairs of the society or trust are conducted properly and their investment are looked after properly.

1.6.3. Advantages of Auditing to others:

(1) Lenders can depend on audited financial statements while taking a decision to grant credit to the business concern.

(2) Tax authorities can depend on audited statements in assessing sales tax, income tax and wealth tax of the business.

(3) Audit of accounts safeguards the interests of the workers and is helpful in the settlement of claim for higher wages and bonus.

(5) Insurance company can rely on audited accounts to settle claims in respect of damage or loss of any business asset by fire, theft etc.

(6) The purchaser of a business can easily calculate the amount of purchase consideration on the basis of audited accounts.

(7) Audited accounts create confidence in the minds of investors in a joint stock company.

1.7 LIMITATIONS OF AUDITING:

Generally following are the Limitations of auditing

1. Non-detection of errors or frauds: - Auditor may not be able to detect certain frauds which are committed by the clients.

2. Dependence on explanation by others: - Auditor has to depend on the explanation and information given by the responsible officers of the company. Audit report is affected adversely if the explanation and information prove to be false.

3. Dependence on opinions of others:- Auditor has to rely on the views or opinions given by different experts viz Lawyers, Solicitors, Engineers, Architects etc, he cannot be an expert in all the fields

4. Conflict with others: - Auditor may have differences of opinion with the accountants, management, engineers etc. In such a case personal judgement plays an important role. It differs from person to person.

5. Effect of inflation : - Financial statements may not disclose true picture even after audit due to inflationary trends.

6. Corrupt practices to influence the auditors: - The management may use corrupt practices to influence the auditors and get a favourable report about the state of affairs of the organisation.

7. No assurance: - Auditor cannot give any assurance about future profitability and prospects of the company.

8. Inherent limitations of the financial statements: - Financial statements do not reflect current values of the assets and liabilities. Many items are based on personal judgement of the owners. Certain non-monetary facts cannot be measured. Audited statements due to these limitations cannot exhibit true position.

9. Detailed checking not possible: - Auditor cannot check each and every transaction. He may be required to do test checking.

10. Auditing is a post mortem examination of accounts.

1.8 AUDITING Vs INVESTIGATION:

Investigation is an enquiry into the accounts and records of a business concern for a special purpose, say, to know the actual financial position of the concern or to know the real earning capacity of the business or to know the extent of fraud, if any. There are many differences between the two. They are:

Points of difference	Auditing	Investigation
1. Objects	The object is to find out whether balance sheet and profit and loss account exhibit a true and fair view of business.	It is undertaken to know the essential facts about a matter under inquiry. It is done with some special purpose of view.
2. Period	It usually covers one accounting year.	It may cover more than one accounting year.
3 Conducted	It is conducted for proprietors only.	It is carried out on behalf of any party interested in the matter.
4. Scope	It is restricted to balance sheet and profit and loss account.	It is wider in scope. It may be carried out beyond balance sheet.
5. Compulsion	Audit is legally compulsory for companies.	It is voluntary. It is required under certain circumstances.
6. Time	It may be conducted at the end of the year.	It may be conducted at any time in case of suspicion about any transaction.
7. Report	Form of report is prescribed. It is presented to the shareholders.	Form of report is not prescribed. It is presented to the client.
8.Appointment	Owners appoint the auditors.	Even third party can appoint an investigator.
9.qualifications	The statutory auditors must possess proper qualifications.	Even an employee preferably a chartered accountant may be appointed as investigator.
10. rework	Re - audit is not generally undertaken.	Re - investigation may be undertaken.

1.9 DISTINCTION BETWEEN AUDITING VS ACCOUNTING:

Points of difference	Accounting	Auditing
1. Meaning	It is recording of all the day to day transactions in the books of accounts leading to preparation of financial statements.	It is the critical examination of the transactions recorded in the books of accounts.
2. Nature	It is concerned with finalization of accounts.	It is concerned with establishment of reliability of financial statements.
3. Objects	The object is to ascertain the trading results.	The object is to certify the correctness of financial statements.
4. Commencement	Accounting Commences when book keeping ends.	Auditing begins when Accounting ends.
5. Scope	It involves various financial statements. It involves maintenance of books of accounts.	It depends upon the agreement or upon the provisions of law. It goes beyond books of accounts.
6. Report	An accountant is not required to submit any report to the proprietor of the business.	An auditor is required to submit a report to the proprietor of the business.
7. period	Accountancy work is conducted continuously throughout the year	Auditing work is generally, conducted at the end of the year or periodically.
8. Qualification	An accountant, who is in charge of accounting work, need not be a qualified person.	An auditor, who is in charge of auditing work, must be a qualified person.
9. Position	An accountant is an insider ie an employee of the undertaking.	An auditor is an outsider, not an employee of the undertaking.
10. Remuneration	An accountant being an employee of the concern is paid regular salary for his work.	An auditor is paid fixed fee for his work.

1.10 Qualification and Qualities of an Auditor:

To be an efficient auditor, an auditor must possess certain professional qualifications and professional and personal qualities.

Professional qualification: - An auditor is a professional accountant. So he must possess certain professional qualifications. Under the Companies Act, an auditor of a joint stock Company must be a Chartered accountant within the meaning of the Chartered Accountants Act of 1949. To be a Chartered accountant, he must pass the C.A examination conducted by the Institute of Chartered Accountants. He must also obtain a certificate from the institute from the Institute of Chartered Accountants to take up public practice of accountancy.

Professional Qualities: - To perform his work efficiently, an auditor must possess certain professional qualities. They are :

1. Knowledge of principles and practice of general accounting.

2. Knowledge of Cost accounting

3. Knowledge of Management accounting

4. Thorough knowledge of techniques of auditing

5. Knowledge of provisions relating to income tax , wealth tax, VAT etc.

6. Knowledge of business laws.

7. Knowledge of economics.

8. Knowledge of Mathematics and Statistics

9. Knowledge of Business Management and Organization and financial administration

10. Knowledge of report writing.

11. Knowledge of technical details of the business under audit.

12. Knowledge of the accounts of the business under audit.

Personal Qualities or General Qualities: - Besides the professional qualities, an auditor must also have certain personal or general qualities to perform his work efficiently and smoothly. The requisite personal qualities are :

(i) Honesty and Integrity.

(ii) Tactfulness

(iii) Vigilance

(iv) An enquiry mind

(v) Methodical

(vi) Care and Skill

(vii) Diligence

(viii) Judgement.

(ix) Responsibility

(x) Impartiality and independence.

(xi) Common sense

(xii) Ability to communicate

(xiii) Ability to work hard

(xiv) Patience

(xv) Courtesy

(xvi) Ability to maintain secrets.

1.11 CLASSIFICATION OF AUDIT OR TYPES OF AUDIT

Audit can be classified on different types:

(1) Classification of Audit on the basis of Organization structure.

(2)Classification of audit on the basis of Degree of independence of the auditor

(3) Classification of Audit on the basis of method or approach to audit work or on the basis of extent of work to be performed or on the basis of conduct of audit.

(4) Classification of audit on the basis specific objectives

1.11.1 CLASSIFICATION ON THE BASIS OF ORGANIZATION OR ORGANIZATION STRUCTURE

On the basis of organization structure, audit may be classified into three types. They are:

(1)Statutory audit

(2) Government audit

(3) Private Audit

Statutory Audit: - Statutory audit refers to the audit of accounts of a business enterprises carried out compulsorily under the provisions of a statute or law. It is is the audit carried out compulsorily under any statute any law.

Features of statutory audit are:

1. Statutory audit is compulsory under law.

2. Statutory audit is required to be conducted by a qualified auditor.

3. In the case of Statutory audit, the rights, duties and liabilities of the auditor are governed by the statute or law applicable to the undertaking.

4. Statutory audit is an independent audit.

5. Statutory audit is an external audit.

6. Statutory audit must be a complete or full audit. It cannot be partial.

Statutory audit is carried out in a number of Organizations, such as

1. Joint stock Companies governed by the Companies Act of 1956.

2. Banking companies governed by the Banking Regulation Act of 1949.

3. Insurance companies governed by the Insurance Act of 1938.

4. Electricity supply companies governed by the electricity supply Act of 1948.

5. Co – operative societies registered under the Co –operative Societies Act.

6. Public and charitable trusts registered under Religious and Endowment Acts

2. Government audit: - Government audit refers to the audit of accounts of Government departments and offices, Government companies and statutory or public corporations.

The features of government audit are

1. Government audit is prescribed for by law.

2. It is conducted either by the comptroller and Auditor General of India and his staff or professional chartered accountant approved by the Comptroller and Auditor General of India. 3. It is internal audit.

4. A government audit is a continuous audit.

Objectives of Government audit

1. To ensure that all payment has been sanctioned by the competent authority.

2. To ensure that every payments is made as per the rules and regulations.

3. To see that the payments have been made to the right persons.

4. To ensure that the expenditure is not excessive.

5. To see that payments are properly classified as capital and revenue.

6. To verify the existence of stocks and stores.

7. To ensure that a proper system of stock taking has been adopted.

Government audit may be classified into three types. They are:

1. Audit of government departments and offices.

2. Audit of Government Companies.

3. Audit of Statutory Corporations registered as statutory corporations.

3.Private audit or Voluntary audit : - Where an audit is not compulsory under any statute, but is undertaken by the owners voluntarily to get the benefit of audit, the audit is called private audit. In other words , private audit refers to the audit of accounts of private enterprises such as a sole trading concerns, partnership firms and other individuals and institutions.

Advantages of private audit:

1. Audit assures to the owners that the accounts of the business are properly maintained and there are no irregularities.

2. It provides a moral check on the employees.

3. It helps the owners of the business to know the real profitability and the state of affairs of their business.

4. Audited accounts serve as a basis for assessment of tax liability.

5. Audited accounts facilitate the process of raising loans from banks and other financial institutions.

6. Audited accounts help in the settlement of dispute and claims between the partners of a firm.

1.11.2 CLASSIFICATION OF AUDIT ON THE BASIS OF DEGREE OF INDEPENDENCE

1. Internal audit

2. External audit

Internal audit:

Internal audit is a continuous and systematic review of the accounting, financial and other operations of a concern by the staff specially appointed for the purpose. In other words, it is the audit of accounts by the staff specially appointed for the purpose.

Objectives of Internal audit:

1. To ascertain whether internal check and accounting systems are adequate and effective.

2. To ascertain whether predetermined policies, plans and procedures have been complied with.

3. To ascertain the reliability of the accounting and other data.

4. To evaluate the performance of the personnel.

5. To ascertain whether the properties of the concern are safeguarded.

6. To suggest to the management the improvements desired in the internal check systems, accounting system etc.

Features of Internal audit:

1. It is generally undertaken by large concerns.

2. It is not compulsory.

3. The scope of internal audit may vary, depending upon the nature and size of the concern.

4. It may be in addition to external audit.

5. It is conducted by the staff of the concern.

6. The techniques and methods of auditing employed in internal audit are the same as those in external audit.

7. It is an integral part of internal control.

8. The staff engaged in internal audit is appointed by the management. They are responsible to the management.

Importance and advantages of internal audit

1. It is helpful to the management to ascertain whether the internal check and accounting systems are adequate and effective to prevent errors and frauds.

2. It helps the management to ascertain whether the predetermined policies, plans and procedures have been complied with.

3. It is helpful to ascertain the reliability of the accounting and other data complied within the organization.

4. It is helpful to evaluate the performance of the personnel.

5. It helps to ascertain whether the properties of the concern are safeguarded.

6. It covers the review of accounting and non accounting matters.

Disadvantages:

It is conducted by staff who may not be a qualified one.

1) It is optional.

2) Quality depends upon the decisions of management.

2. External Audit.

Audit conducted by independent qualified person and examines the books of accounts and report to the management.

Difference between Government Audit and Commercial Audit

Government Audit	Commercial Audit
1. It is adopted in government departments, government offices and Government Company.	1. It is conducted in private enterprise.
2. It is compulsory.	2. It is optional.
3. It is conducted by CAGI and his staff and qualified staff.	3. It is conducted by professionally qualified persons.
4. Continuous audit.	4. Pèriodical audit.
5. Disbursing officer is responsible for the work of audit.	5. Disbursing officer is not responsible.
6. Treasury officer undertake preliminary audit.	6. There is no preliminary audit.

1.11.3. ON THE BASIS OF CONDUCT OF AUDIT OR METHODS OR APPROACH TO AUDIT WORK

1. Continuous Audit.

Continuous audit is one where the auditor's staff is occupied continuously on the accounts whole the year round and performs interim audit. It is an audit under which detailed examination of the books of accounts is conducted continuously throughout the year. It is continuous review of the accounts of the organization. It is generally applicable to banking company and insurance company.

Advantages:

1) Easy and quick discover of errors and frauds.

2) Technical knowledge.

3) Quick presentation of accounts.

4) Keep the client staff regular.

5) Moral check on the client's staff.

6) Efficient audit.

7) Preparation of interim accounts is very easy.

8) Audit staff can be kept busy.

Limitations:

1) Alteration of figures.

2) Dislocation of the work of the client staff.

3) Expensive.

4) Queries may remain outstanding

5) Extensive note taking may be necessary.

6) Chance for collusion between client staff and audit staff.

7) Mechanical and monotonous.

Precautions or steps to be taken to overcome the drawbacks:

1) Well dream up audit program should be followed by the auditor.

2) No alterations to be allowed after the accounts are audited.

3) If any alterations are made, it should be made in the rectification entries in the journal.

4) A note should be made in respect of queries asked.

5) If any alterations are made in figures before auditing, a special tick mark must be made.

6) Recommend surprise visit.

7) Rotate the audit work among auditors.

2. Final Audit or Annual or periodical audit:

It is an audit carried out after the preparation of financial statement. It is an audit where the auditor takes up his work of checking the books of accounts only at the end of the accounting year. In this case, the audit work is commenced and completed in a single uninterrupted session.

Advantages:

1) Cost of audit is less than that of continuous audit.

2) Audit work is completed in one continuous sitting.

3) Not causing any dislocation of client work.

4) No possibility of alteration of figures.

5) It is not mechanical and monotonous.

6) Less chance for collusion between client staff and audit staff.

7) There is no lose the thread of the work.

Limitations:

1) Errors and frauds remains in the accounts for long period of time.

2) Postmortem examination of accounts.

3) Little time for checking.

4) Rely upon test checking.

5) Not suitable for imposing moral check on the client staff.

6) Not helpful for preparing interim accounts.

7) Not suitable for large size organizations.

3. Interim Audit:

It is an audit conducted between two annual audits. In other words, it is the audit conducted in the middle of the financial year. It is carried out for some specific purpose for declaring interim dividend, ascertaining interim profit.

Advantages:

1) Quick discovery of errors and frauds.

2) Imposes moral check on client staff.

3) Helpful for speedup the final audit.

4) Useful for publication of interim figures.

5) Audit becomes easy and can be completed without lapse of time.

4. Balance sheet audit :

Balance sheet audit is a type audit which concentrates mainly on the verification of the items in the balance sheet such as capital, reserves, profit and loss account balance, liabilities and provisions and all the assets of the business.

5. Occasional Audit:

An occasional audit is an audit which is conducted once a while, whenever the need arises. In other words, it is a kind of audit which is not conducted on regular basis, but is conducted for a special event, time or purpose.

6. Complete Audit :

Complete audit is a kind of audit under which all the records and books of accounts are audited by an auditor.

7. Partial Audit:

It is a kind of audit the scope of which is limited one. It is carried out in respect of only a part of the books of accounts of a business, for a part of whole of the period.

1.11.4 CLASSIFICATION OF AUDIT ON THE BASIS OF SPECIFIC OBJECTIVES

1. Cash Audit: - It is a type of partial audit which is undertaken for only cash receipts and cash payment.

2. Special Audit:- It is a kind of audit with some special object in view. It is a fact finding enquiry.

3. Operational Audit: - It is an efficient examination of the various operations of the different functional area of business.

4. Proprietary Audit: - It is an audit in which various actions and decisions are examined to find out whether in public interest and whether they meet the standard of conduct.

5. Efficient Audit: - It is an evaluation of overall efficiency and performance of an organization.

6. Tax Audit: - It means audit for tax purpose. Audit required to be carried out of income tax act of 1961. It is conducted by certified Chartered Accountant.

There are certain circumstances in which tax audit is necessary.

1. Compulsory tax audit under section 44 AB of the Income tax Act 1961

2. Tax audit for claiming deductions and Reliefs under the Income Tax Act.

3. Tax audit for Tax Consultancy and Representation.

7. Cost Audit:- It is a thorough examination of the cost accounting records of a company by a cost auditor to ensure that they are accurate and they also follow to the cost accounting principles, procedures and plans.

Objectives:

1) Verifying the accounting entries related in the cost books.

2) To find out whether the cost records have been properly maintained.

3) To verify whether the cost accounting principles are complied with.

4) To find out whether the cost statements are properly dream up.

5) To verify the items of cost expenditure are correctly incurred.

6) To find out the efficiency and inefficiency of handling of material, labour and other expenses.

7) To check up the overall working of the cost accountant.

8) To reduce the volume of work of the external auditor.

9) To detect errors and frauds.

8. Management Audit:

It is the critical examination, scrutiny and appraisal of plans, policies, procedures, objectives, means and operational area of the organization. It is the audit of managerial actions and decisions. It is the audit of activities of various level of the managers.

Objectives of Management audit:

1. To identify the overall objectives of an organization.

2. To pinpoint the deficiencies and defects in functional areas and suggest remedies for improvement.

3. To assist the various level of management in discharge their duties.

4. To help the management in achieving co- ordination among the various departments.

5. To ensure that management objectives are achieved.

Advantages of Management Audit:

1. It identifies the overall objectives of the organization.

2. It reviews plans, policies, procedures and controls.

3. It assesses the performance in each functional area

4. It also ascertains the motivational system in operation in the business.

5. Suggesting ways and means for the attainment of management goals.

Criticism against management audit:

1. It is argued by some managers and accountant that management audit is a vague concept and so, it serves no material purpose.

2. Management audit may discourage the managers from undertaking tasks which are useful to the organization.

3. It is argued that it will adversely affect to the efficiency and production.

9. Social Audit:

Social audit is a systematic study and evaluation of a business enterprise's social performance as distinguished from its economic performance. Social audit is intended to evaluate the social performance or social contribution of a business organization. TISCO firstly adopted social audit.

1.12 PRELIMINARY STAGE OF AUDIT WORK OR PREPLANNED ACTIVITIES OF THE AUDIT WORK OR STEPS TOBE TAKEN BY THE AUDITOR BEFORE COMMENCEMENT OF THE AUDIT OR AUDIT PLANNING

An auditor must prepare well before he actually commences a new audit. He has to take certain steps or bear in mind certain considerations before commencing a new audit. These steps are known as preliminary steps or general steps. The following are the important preliminary or general steps to be taken by an auditor in all types of concerns before the commencement of a new audit:

I. Obtaining letter of appointment. Auditor should satisfy himself that he has properly appointed.

II. Knowing the scope of his studies.

III. Ascertaining the nature of the business undertaken by the client enterprise.

IV. Knowledge of the organizational structure of the client business. Pattern of authority and responsibility are revealed through the organizational structure.

V. Obtaining the list of principal officers of the client business.

VI. Knowledge of internal check, internal control and internal audit

VII. Knowledge of system of accounting of the client business.

VIII. List of books maintained in the organization.

IX. Detailed study of important documents of the organization.

X. Study of prospectus, preliminary contracts etc of the organization.

XI. Study of the previous year financial statements.

XII. Enquiry about the reason for the change of the auditor.

XIII. Giving instructions to the client.

a) The books should be closed before the audit.

b) Voucher should arranged date vise.

c) Schedules should be kept for ready reference such as schedules of debtors and creditors, list of bad and doubtful debts, schedule of investment, schedule of depreciation etc..

XIV. Division of audit work among the auditors.

XV. Preparation of audit program.

1.13 AUDIT TECHNIQUES

Techniques of audit are the methods or means adopted by an auditor for the collection and evaluation of audit evidences for his audit work. Important audit techniques are

1) Vouching

2) Confirmation

It is the technique through which an auditor communicates with outside parties.

3) Enquiry

Enquiry is the technique of making enquiries with the responsible officials of the client and obtaining in depth information.

4) Reconciliation

It is the technique of identification and explanation of the items which cause the difference between two related items.

5) Physical examination

It is the technique of ascertaining the actual existence.

6) Test checking

7) Analysis of financial statements

8) Scrutiny or scanning

It is the technique of making a quick and overall examination of books of accounts to verify whether the transactions are correctly and completely recorded in the books of account.

9) Extension verification

It is the technique of multiplying two or more amounts to verify whether the totals have been correctly arrived at.

10) Posting verification

11) Documentary examination

12) Observation

It is the technique by which an auditor observes or witnesses an act performed by others.

13) Footing

Footing is the technique of adding the columns of different accounting figures to test the accuracy of the total.

14) Flow charting

It is the technique of using flow chart to describe graphically the cause of the transactions through different stages from the beginning to the end.

1.14 AUDITING AND ASSURANCE STANDARDS

An auditor Should have a thorough understanding of the auditing practices that are generally accepted as standards to conduct his audit effectively. For this purpose , he has to study and understand the professional announcement on auditing. The objective of auditing and assurance standards issued by the ICAI is to secure compliance by the members of the institute on matters which are important for the proper discharge of their audit work.

Various Auditing and Assurance Standards issued by ICAI :

1. AAS 1 : Basic principles governing audit

2. AAS 2 : Objective and Scope of financial Audit

3. AAS 3: Documentation

4. AAS 4: Fraud and error

5. AAS 5 : Audit Evidence 6. AAS

6 : Risk Assessment and Internal Control

7. AAS 7 : Relying upon work of an Internal Auditor

8. AAS 8 : Audit planning

9. AAS 9: Using the Work of an Expert.

10. AAS 10 : Using the work of another Auditor.

11. AAS 11 : Representation by Management.

12. AAS 12 : Responsibility by joint Auditors.

13. AAS 13 : Audit Materiality

14. AAS 14: Analytical Procedures.

15. AAS 15 : Audit Sampling.

16. AAS 16: Going Concern Assumption.

17. AAS 17: Quality Control for Audit work.

18. AAS 18 : Audit of Accounting Estimate

19. AAS 19 : Subsequent events.

20. AAS 20 : Knowledge of the Business

21. AAS 21: Consideration of Laws and regulations in an Audit of Financial Statement.

22. AAS 22 : Initial Engagement

23. AAS 23 : Related Parties

24. AAS 24: Audit Consideration relating to Entities using Service Organisations. 25. AAS

25: Comparatives

26. AAS 26 : Terms of Audit Engagement

27. AAS 27 : Communication of Audit Matters with those entrusted with Governance.

28. AAS 28 : Auditor's Report on Financial Statements.

29. Audit in Computer information system Environment

AAS – 1 :Basic principles governing an audit: - The basic principles governing an audit are:

1. Integrity, objectivity and independence: - This principle suggests that an auditor must be straight forward, honest sincere, fair and objective in the performance of his professional duties.

2. Confidentiality: - This principle implies that the auditor must not disclose any information acquired by him in the course of his audit work to any person.

3. Skills and Competence: - This principle means that an audit should be performed and the audit report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing.

4. Work performed by Others: - This principle implies that when an auditor delegates his work to his assistants or uses the work performed by other auditors and experts , he will continue to responsible for performing and expressing his opinion on the financial statement.

5. Documentation: - This principle implies that all matters which are important in providing evidence that audit was carried out in accordance with basic principles should be adequately documented.

6. Planning:-This principle suggest that an auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner.

7. Audit evidence: - This principle implies that an auditor should obtain sufficient appropriate evidence to draw reasonable conclusions.

8. Accounting system and Internal Control: -This principle suggests that an auditor should reasonably assure himself that the accounting system and internal control are adequate.

1.15 AUDIT PLANNING

In order to ensure a high standard of performance, it is important that the auditor should prepare adequately for his work. Planning for an audit, just like every human endeavour, is essential for the smooth performance of the audit work and its successful completion. Planning ahead for an audit work will not only guarantee a valid audit opinion but will also help the auditor to ensure that:

(a) The audit objective is established and achieved;

(b) The audit is properly controlled and adequately directed at all stages;

(c) High risk and critical areas of the engagement are not omitted but that adequate attention is focused on these areas; and

(d) The work is completed economically and expeditiously, hence, savings on audit resources.

It is important to distinguish between an audit planning memorandums. Audit plan relates to preparations made by the auditor for one specific audit engagement. While audit planning memorandum is a standing arrangement made by the auditor for the continuing engagement of a particular client. Hence, audits plan for the audit of one client for one year while audit planning memorandu is a standing plan for the continuing audit of a client from year to year.

Points for Consideration in Audit Planning

Points for Consideration in Audit Planning Points for Consideration in Audit Planning Audit planning requires a high degree of discipline on the part of the auditor. In order to make the planning more meaningful, the auditor shouldtake into consideration the following matters in relation to the audit engagement:

(a) Preliminary Work to be Done in Addition to the Real Audit Work: This will include such matters as stocktaking, cash count, debtors'circularisation and review of previous year's working papers. This will remind the auditor of those matters brought forward from the previous year and any other points to be resolved in the current year or problems anticipated.

(b) Changes in Legislation or any Auditing Standards or guidelines: Guidelines The promulgation of the Companies and Allied Matters Act, Cap. C 20, LFN 2004, brought with it a lot of changes in accounting and auditing requirements of companies. Such legislations whether in respect of all companies or particular industrial group, must be reviewed ahead of the engagement in order to determine their effects on the operations or reporting requirements of the enterprise.

(c) Analytical Review of Available Management Accounts and Other Management Information that Relate to the Accounts: This will assist in establishing valuable ratios and indicators that will guide the auditor. For instance, the computation of the gross profit percentage compared with that of the previous year will provide a good indicator to the auditor of the accuracy and reliability of sales and cost of sales.

(d) Changes in the Business or Management: The appointment of a new Finance Controller and the establishment of a new business line or the creation of a new branch are significant changes in the circumstances of the company which will necessitate changes in the existing audit plans.

(e) Changes in the Accounting System: The introduction of computers such that when a company introduces significant changes in its operating procedures will require a review and evaluation of the system of internal control.

(f) Deadlines Established for the Submission of Audit Report: Where a client has set deadlines for its statutory activities such as the annual general meeting, it is important for the auditor to work in line with such programmes.

(g) Use of rotational testing and verification: In practice, the auditor may not carry out a hundred percent testing or verification of the client's transactions or segments of the business. Where rotational testing or verification is adopted, it will be necessary for the auditor to determine ahead of the date of the engagement which aspects of the business should be selected for testing or verification. An example of rotational testing could be applied on the client's branches to be visited.

Points for Consideration in Audit Planning Memorandum

Audit planning memorandum should cover the following standing matters which are designed to achieve the desired audit objectives:

(a) Terms of Engagement: In the case of a new audit engagement, a letter of engagement should be prepared as part of the overall plan of the audit. Even in subsequent visits,the letter of engagement should be reviewed in the light of current circumstances to ensure that all aspects of the work undertaken for the client are covered in the letter especially as they relate to taxation, accountancy, staff development and executive search.

(b) Audit Risk Areas: The auditor should critically review all the areas of high risk in order to ensure that the planned procedures adequately cover such areas and that competent staff have been assigned to these areas. High risk areas may relate to the nature of the items, such as cash for a retail establishment with numerous collection points and outdoor disbursement locations. Risk may also relate to a high probability of error as in the case of stocks whose quantities are subject to estimation and are susceptible to pilferage. The risk may also relate to the structure of the organisation especially in cases of joint ownership of an organisation, where the owners are not equally represented in the management. There is therefore the risk of withholding key information from some of the directors.

(c) Assets and Liabilities: These will require detailed plans since they are of continuing relevance to the financial statements of many years and the relevant vouchers may not be readily accessible. The plans relating to assets should clearly disclose their history such that current movements may easily be ascertained and adequately verified. These will apply mainly to plant and long term loans.

(d) Presence of Internal Auditor: Wherever an internal auditor exists in an organisation, the auditor should develop suitable plans to review the technical competence of the internal auditor, his degree of independence and scope and quality of his work in order to determine the extent of reliance to be placed on his work and to identify the areas of work overlap.

(e) The Need for Specialists: The auditor should determine ahead of his visit those aspects of the work that may require the services of specialists. This may be internal or external specialists as relates to stocks, specialist valuation for insurance or computer applications.

(f) Audit Approach: Based on the review of the system of internal control, the auditor should be able to decide on the audit approach to adopt. This will be based on the extent of reliance to be placed on the system of internal control.

(g) Timetable: A critical aspect of the audit is the timetable. The auditor should establish plans to ensure that for each year, the audit is completed within any stated deadline for submission of the report.

(h) Staffing: The auditor should plan for adequate number of staff with the required skill for the audit. The training of audit staff is a long term process which will require that even from the initial appointment of the auditor, he should take steps to train suitable staff in sufficient number to handle the audit of the client.

(i) Fees: Based on plans already established in terms of time, staff and materials, the auditor should plan for his fees to cover staff salaries, overhead costs and leave a sufficient margin for the partners' share of profit and pension scheme. The planned fees must be discussed with the client, if not already agreed.

1.16 AUDIT PROGRAMME

An audit program, also called an audit plan, is an action plan that documents what procedures an auditor will follow to validate that an organization is in conformance with compliance regulations. The goal of an audit program is to create a framework that is detailed enough for any outside auditor to understand what official examinations have been completed, what conclusions have been reached and what the reasoning is behind each conclusion. The framework should explain the audit's objectives, its scope and its timeline. The audit program should also describe how working papers — the documented evidence of the audit — will be collected, reviewed and reported.

1.16.1 Objectives Of Audit Programs

When developing an audit program, the internal auditor and its associated audit team should start with outlining the audit's objectives, goals and obligations.

Audit program objectives help direct planning of the audit report and are based on the policies, procedures and guidelines unique to the company. These objectives may relate to and outline how the auditors will maintain efficiency, professionalism and a specific code of conduct during audit procedure.

In addition to relevant regulatory compliance mandates, objectives for audit programs should consider aspects such as management priorities, business intentions, system requirements, business structure, legal and contractual mandates, the expectations of customers and other interested parties, potential risk management vulnerabilities, and any corrective action taken based on previous audits.

1.16.2 Types Of Audit Programs

Different types of audit programs include standardized audit programs, tailored audit programs and compliance audit programs. Standardized audit programs, which are available for many different industries, can be used proactively to help an organization create its own internal compliance framework and internal audit program. For example, the International Federation of Accountants publishes financial audit standards called the International Standards on Auditing. A standardized audit program is different than a fixed audit program, which is defined as an audit program that cannot be changed during the course of an audit.

Tailored audit programs are different from standardized audit programs in that they cater audit procedures to match specific needs of the auditing entity. These audit programs are "tailored" to reference specific areas such as business procedures, legal documents and assets. By targeting these specific requirements through tailored audit programs, the company can more quickly identify potential compliance lapses and develop internal controls to offset these vulnerabilities.

A compliance audit program outlines how an organization will adhere to regulatory guidelines. The details of compliance audit program will vary depending upon factors such as whether an organization is a public or private company, what kind of data it handles and if it transmits or stores sensitive financial data. For instance, Sarbanes-

Oxley Act requirements state that electronic communication must be backed up and secured with disaster recovery infrastructure, while financial services companies that transmit credit card data are subject to Payment Card Industry Data Security Standard (PCI DSS) requirements. In the Unites States, publicly traded companies must report results of internal control audits to the Securities and Exchange Commission (SEC). In each case, an organization's audit program outlines how the company will maintain compliance with regulatory compliance rules.

Specimen copy of an Audit Programme

The following is a specimen copy of an audit programme for the year ended 31 March 2015.

Particulars	Period of Verification	Name of the Persons	To be completed by	Completed on
Cash Book:				
Vouching:	First 3 and Last 3 Months			
Posting:				
Casting:	First 2 and Last 2 Months	A, B	25th July	30th July
	Supervisor Signature:			
	Signature of Audit Staff:			
Purchase Day Book:				
Vouching:	First 1, 2, last and any 1 month in the middle	C, D	29th July	31st July
Posting:				
Casting:	All the above 5 months			
	Signature of Audit Staff:			
	Supervisor			

1.16.3 Advantages Of Audit Programme

The advantages of Audit Programme are:

1. Provides a clear set of instruction on the work to be done.
2. Provides clear record of work done and by whom.
3. Work can be reviewed by senior auditor.
4. Work will not be duplicated.
5. No important work will be overlooked.
6. Evidence of work done is available for use in defending charge for negligence.
7. Audit Programme serves as a shield against any charge of negligence by a client on the part of the auditor.
8. It provides an assurance that no material aspect of audit examination has been overlooked.
9. It pinpoints the audit work to be done by audit staff and that has already been done.
10. IT facilitates in the distribution of work among the audit staff according to their knowledge.
11. Audit programme of last year serves as a basis in preparing the audit programme for subsequent year.
12. Before signing the audit report, final review of work done can be easily made.
13. It ensures the adherence to International Accounting and Auditing Standards.
14. Responsibility of each audit staff (articled clerk) is fixed.

1.16.4 Disadvantages Of Audit Programme

The disadvantage of Audit Programme are as follows:

1. Work may become mechanical.
2. Parts may be executed without regard to whole scheme.
3. Programme may rigidly followed.
4. Initiative may be lost.
5. Audit staff may not have opportunity of showing independent thinking, intelligence and initiative due to adherence to audit programme.
6. Audit programme may not cover everything that might come up during the course of audit.
7. It may create rigidity in audit examination if not frequently reviewed and updated.

8. Audit staff is bound to follow audit programme mechanically irrespective of changes in internal control introduced by the client.

9. Audit staff may defend by claiming that a particular audit examination was not provided by audit programme.

10. Fixed auditing programme will have its own limitations.

11. Clients staff knowing the extent and methods of checking followed by auditor may devise means to escape detection of fraud by auditor.

1.17 AUDIT NOTE BOOK

During the course of audit the audit clerk experiences several difficulties. He cannot remember everything at all time. So he maintains a book with him in which he makes note of important points and queries, which he has to refer to the client's staff or clarify with the chief auditor. Such a book is called Audit Note Book. It is an essential book used to note important points that shall be included in the Auditor's report. It is a complete record of doubts and their clarification. It helps the auditor in his subsequent audits. It is also used as a guide to the other audit clerks.

To sum up audit note book is nothing but a dairy, maintained by the audit staff for the purpose of recording certain points which require further clarification, explanation and investigation. This book generally includes the errors found out during the course of audit, difficulties observed and doubtful queries of various accounting records, etc. This note book usually forms a part of the permanent audit file.

Audit note book is also called as a **remembrance book**. It contains all matters that come to the notice of the auditor in the course of audit. It also plays an important part in defending the auditors if any legal action is brought against them. Audit note book can be used as authentic evidence in support of the work done by them.

Audit note book may be in the form of a bound book or of a permanent file of the audit office. It may also be in the form of loose sheets where the auditor files these sheets subsequently according to the sequence of dates for the future reference.

Definition of Audit Note Book

E.L. Kohler formulated a detailed definition for the term. According to him,

"Audit note book is a record, used chiefly in recurring audits, containing data of work done and comments outside the regular subject matter of working papers. It generally contains such items as the audit programme, notations showing how sections of the audit are carried out during successive examinations, information needed for the auditor's office and for staff administration, personnel assignment, time requirements and notations for use in succeeding examination".

1.17.1 Contents of Audit Note Book

An audit notebook generally consists of the following information:

1. The nature of the business and summary of important documents relating to the constitution of the business such as Memorandum of Association, Articles of Association or Partnership Deed, etc.

2. A list of the books of accounts maintained.

3. Particulars as to the system of accounts followed and the system of internal check in force.

4. Names of principal officers, their duties and responsibilities.

5. Progress of audit work together with the dates on which the work was undertaken and completed.

6. Extracts from correspondence with different authorities.

7. Audit programme.

8. Allocation of work among different audit staff.

9. All queries which have not been clarified so far.

10. Lists of missing receipts, vouchers, bills, etc.

11. Any special point arising during the course of audit to which the attention of the auditor must be drawn.

12. Particulars of cash balances, investments, fixed deposits, and the reconciliation statements of principal bank accounts.

13. Extracts of the minutes and contracts affecting the accounts.

14. Record of audit work done with dates of commencement and of completion.

15. Particulars regarding the financial policies followed by the business.

16. All mistakes and errors discovered.

17. Points to be incorporated in the audit report.

18. Points, which need further explanations and clarifications.

19. All important matters for future reference at subsequent audits.

20. Information of permanent nature relating to the business and notes of all important technical transactions.

These matters are very useful in preparing the audit programmes for subsequent audits.

1.17.2 Importance of Audit Note Book

1. Audit note book shall be taken as reliable evidence even by the Court of law in case of dispute or if the auditor is charged with negligence.

2. It is useful for drawing the audit programmes.

1.17.3 Advantages of Audit Note Book

Some the advantages of audit note book are given below:

1. Audit note book enables the auditor to record important points, which arise during the course of his audit; otherwise he might forget these points.

2. An auditor can produce this book as a documentary evidence in a suit filed against him for negligence or misfeasance.

3. It facilitates the preparation of the audit report.

4. If the assistant in charge is changed before the completion of a particular work, it acts as a guide and makes the completion of balance work easier.

5. A credit note book makes the work of audit convenient because all the important details about audit can be recorded in this book and, as such, any change in the staff of the auditor does not disturb or dislocate the work of audit.

6. It can help in making an assessment of the work of audit clerks.

7. It provides a key to evaluate the efficiency of the audit staff.

1.17.4 Disadvantages of Audit Note Book

There are, however, certain disadvantages of audit note book. They are as follows:

1. Very often, it creates misunderstanding between the client staff and the audit staff.

2. If it is not properly and carefully prepared it cannot be used as evidence against the auditor for negligence.

3. It develops a fault finding attitude in the minds of the staff of the audit.

4. Audit staff has to depend too much upon the client's staff for its preparation.

1.18 AUDIT WORKING PAPERS

Audit working papers include those papers and documents, which consist of details about accounts, which are under audit. They are the written, private materials, which an auditor prepares for each audit. They describe the accounting information, which he obtained from his client, the method of examination used, his conclusions and the financial statements.

Definition of Audit working papers

The Institute of Chartered Accountants of India insists on the preparation and keeping of adequate working papers. According to the Institute of Chartered Accounts of India,

"Working papers must include audit programme, queries, explanations given for the queries, schedules of important items like depreciation, inventories, confirmation from third parties, certificates issued by the management, banks, etc"

Thus, the standard requires an auditor to maintain adequate working paper. Working papers provide basic evidence of audit conducted in accordance with standard audit practices. They help the auditor in writing the report. The quality of audit work performed by the auditor can be judged by the character and contents of working papers prepared and maintained by the auditor.

According to Prof. Meigs,

"The term working papers is a comprehensive one and includes all the evidences gathered by the auditor to show the work he has done, the methods and procedures he has followed and the conclusions he has developed ".

1.18.1 Objectives of audit working papers

1. The working papers serve the auditor both as useful audit tool as well as a permanent record of the audit work performed.

2. They are useful to the auditor to control the current year's audit work.

3. They constitute a reliable guidance for planning the future audit assignments.

4. A review of the audit working papers gives an assurance that the audit work is both accurate and complete.

5. The auditors arrange the data properly in the working papers. Hence, the data become more meaningful and useful for the purpose of the,audit.

6. Working papers are necessary to corroborate the work and the findings of all the audit staff.

7. The chief auditor is assured that the opinion is supported by the findings of their audit staff.

8. The working papers constitute complete and conclusive evidence in future as to the entirety and completeness of the audit work.

1.18.2 Contents of audit working papers

AAS 3 states working papers should record the auditor's plan, the nature, timing and extent of the audit procedures performed; and the conclusions drawn from the evidence obtained.

Generally, audit working papers consist of the following details:

1. Schedule of debtors and creditors.

2. Trial Balance.

3. Certificate of officials regarding certain important matters like bad debts, valuation of stock, unpaid expenses, accrued incomes, etc.

4. Statement of depreciation.

5. Correspondence between the auditor and the debtors, creditors, etc. of the client.

6. Investment Schedules.

7. Confirmation by the bank regarding the bank balances of the client.

8. Bank Reconciliation Statement.

9. Important extracts from the minute books such as agreement with vendors, hire purchasers, selling agents, etc.

10. Detail of cash balance checked.

11. Adjustment entries.

12. Contingent liabilities certified by the management.

13. Draft financial accounts.

14. Details of clarifications made during the course of audit.

15. A copy of the auditor's book.

16. Letters of representation.

17. Correspondence from legal advisors

18. Pertinent memoranda relating to the audit.

19. Data relating to the review of internal control.

20. Stock holder equity and the minutes.

21. Test of transactions.

1.18.3 Purpose of Audit Working Papers

The following are the purposes of Audit working papers:

1. Working papers represent the volume of work performed by the auditor and his staff. Hence, they enable the easy drafting and preparation of a detailed audit report.

2. The various minute details and aspects of the audit report can be well substantiated based on the findings summarized in the report.

3. They become a valuable documentary evidence for the auditor on the occasions when he has to defend himself against the charges of negligence, etc. leveled against him.

4. They enable auditor to coordinate and organize the work of audit clerks.

5. They enable the auditor to advice his client regarding the improvement of the system of internal check and efficiency of the accounting system.

6. They serve as a guide to the auditor in subsequent examinations and help the auditor to plan for the succeeding year.

7. They serve as a means to give training to the audit clerks to summarize the work done by them.

1.18.4 Essentials of Good Working Papers

The essentials of good working papers are as follows:

1. Working papers should be complete in all respects. They should contain all necessary information so that they may be of maximum use.

2. They should be properly organized and arranged so that one may not experience any difficulty in locating a particular matter.

3. They must contain accurate information so that they will be relied upon.

4. They should contain the facts, which are of self-explanatory.

5. The facts given in working papers should be readily apparent to the reader.

6. The relevant details should always be kept in the working papers. All irrelevant information should be kept out of the space in order to enhance their utility for the purpose for which they are kept.

7. The audit working paper files should be properly preserved and filed. These files should be serially numbered and indexed so that they may be made available whenever they are needed.

8. Paper used for the preparation of working papers should be of better quality and uniform size.

9. Sufficient space should be left after each note so that any decision taken by an auditor may be written in that space.

1.18.5 Preservation of Audit working papers

Working papers are to be retained in the safe custody of an auditor. The client's staff or third parties should not have access to working papers. The documents are to be preserved for sufficient length of time in order to satisfy the needs of auditor and professional requirements of record retention. The auditor has to maintain the confidentiality of the affairs of the client.

1.18.6 Ownership of Audit working papers

The working papers are the matters documented by the auditor. So they are his property. Although, the client may claim them as a record of his business matters, the auditor cannot part with them as his conclusions are based on them and as they provide evidence of the audit work carried out according to the basic principles.

The legal observation in the case of Sockockinsky Vs Bright Grahame & Co. is that

"The working paper belongs to the auditor not to the client, as the auditor is an independent contractor and not the agent of the client".

Similarly the Court of Appeal in the case of Chantrey Martin & Co. Vs Martin held that

"The working papers prepared by the auditor are the property of the auditor".

Thus, the working papers are the property of the auditor. They are not a part of, nor substitute for, the client's accounting records.

1.19 INTERNAL CONTROL

Internal control is the whole system of control established by the management for the proper conduct of various activities of the organization. It is not only internal check and internal audit but also the whole system of control financially and otherwise established by the organization in order to carry out the business in orderly and efficient manner.

It is useful for the organization to safeguard the assets and serve the reliability of accounting records. In other words, it is the overall control adopted by the organization.

1.19.1 Features:

1) It is the overall control adopted by the management.

2) It comprises of plans, methods and procedures for the effective control of the operations of the business.

3) It comprises of internal check, internal audit, accounting system and administrative control.

4) It is established by the management.

5) It intended to help the management to run the business efficiently.

1.19.2 Objectives:

1) To ensure that transactions are recorded proper books of account.

2) See that all transactions are carried out only on account of a sanction of authority.

3) See that management policies and decisions are properly implemented.

4) To ensure efficient conduct of business.

5) To evaluate the efficiency of performance of the various personnel.

6) To safeguard the assets of the organization.

7) To safeguard the interest of the organization.

8) To ensure reliability of accounting records.

9) To ensure the periodical verification of assets.

1.19.3 Scope or Area of internal control:

1) Accounting Control. It ensures the reliability of accounting transactions. Accounting transactions are recorded by using accounting principles.

2) Administrative Control. It is concerned with distribution of authority and decision making process of management. Overall operation efficiency of the organization is ensured.

1.19.4 Essentials of Good internal Control:

1) It should be clear and well developed plan of organization.

2) There should be competent and trust worthy personnel for the success of the business.

3) There should be segregation of duties: - Operational duties are separated from recording duties. Physical handling of asset must be separated from accounting records.

4) There should be administrative traditions and practices for the performance of the duties.

5) There should be well developed and adequate accounting system.

6) There should be a sound system of maintenance and recording of accounts.

7) There should be effective internal check system.

8) There should be good audit system.

9) Periodical review of internal control.

1.19.5 Advantages Of Internal Control

A. Advantages to the business:

1) Provide accurate and reliable data to the management for taking correct decisions.

2) Ensure that policies and procedures are complied with.

3) Promotes operational efficiency.

4) Help to attain organizational goal.

5) To safeguard the assets of the organization.

6) To ensure the reliability of accounting records.

B. Advantages to the auditors:

1) Helps the auditor in framing the audit program.

2) To ascertain extent of test check can apply.

1.19.6 Limitations of Internal control:

1) Expensive.

2) Transactions of unusual nature may not be subject to internal control.

3) Human errors remain in any system of control.

4) Limitation of preventing frauds committed through collusion between persons.

5) It may not be keep pace with the change in the condition.

1.20 INTERNAL CHECK

It is an arrangement of accounting work under which the work of one person comes under the security of another person. So, that it is not possible to commit fraud without collusion between two or more persons. In other words, it is an arrangement of accounting system under which no one person is allowed to carry out one work completely Specialization & division of work is important one. The work of one staff is automatically checked by another person in order to locate errors and frauds.

1.20.1 Advantages:

A. Advantages to business:

1. Proper division of work
2. Fixation of responsibility
3. Greater efficiency of the staff.
4. Increased carrying capacity.
5. Early detection of errors and frauds.
6. Easy preparation of final account.
7. Truth and accuracy of accounting can be available.

B. Advantages to Owners:

1. Genuineness and accuracy of the account.

2. Overall efficiency, economy in operations, increased profit etc..

C. Advantages to Auditor:

1. There is no need for detailed examination of book of accounts.

2. It reduces burden.

Objectives:

1) Proper division of work.

2) Minimization of errors and frauds.

3) Easily detection of errors and frauds.

4) Ensures the reliability of accounts.

5) Easily preparation of final accounts.

6) Simplification of the external auditors work

1.20.2 Limitations:

1) Suitable only for big concerns.

2) Sacrifice of quality for quickness.

3) Certain type of disorder, confusions etc... in the working of the organization.

4) Useful only when there is no collusion between employees.

5) Risky for the auditor.

1.20.3 Principles and essential of good internal check system:

1) Simple, easy workable and effective.

2) Not be too expensive.

3) Carefully devised and properly regulated.

4) Authority should be clearly defined.

5) Proper division of responsibility.

6) Division of work among the staff.

7) Work of similar nature should be entrusted with one person to ensure specialization.

8) No individual should be allowed to perform one work completely.

9) Work should be distributed in such a way that the work of one staff is automatically check another.

10) No employee should be allowed to remain a particular job for a long period.

11) No employee of the concern should be rely upon too much.

12) Proper reporting to the management.

13) Proper system of filing vouchers.

14) Safeguards should be prescribed for the safe custody of unused cheque book, securities etc…

15) There should be a self balancing ledger system.

16) All incoming letter should be opened by responsible officers.

17) The receipt of cash and disbursement should be entrusted to different personnel.

18) Cashier should have no access to ledger.

19) All remittance received should be deposited in a bank immediately.

20) All cash payments should be made by a cheque.

21) Cash and bank balance should be verified frequently.

22) Petty cash payment should be on imprest system.

23) There should be effective control of receipts and issue of goods.

24) There should be a perpetual inventory system.

1.21 DIFFERENCE BETWEEN INTERNAL CONTROL, INTERNAL CHECK AND INTERNAL AUDIT

Difference between internal control, internal check and internal audit

Internal Control.	Internal check.	Internal audit.
It is the whole system of control established by management.	It is the arrangement of accounting work under which the work of one person comes under another.	Continuous review of records by staff appointed for the purpose.

Scope of internal control is very wide. it includes internal check and internal audit. The objective is to safeguard the asset of enterprise.	Scope of internal check is less. Objective is to locate errors and frauds.	Scope of internal audit is less that of internal control wider than internal check. The object of internal audit is to assure the management that the system of internal control and internal check in operation are in effective in design and operation.
There is no separate staff.	There is no separate staff	It is conducted by the staff specially appointed for the purpose called as internal auditor.
Internal control is exercised when the work of employees in progress.	Internal check is exercised when the work of employee is in progress.	It is undertaken by the auditor after the work has been completed.
Any organization can adopt internal control.	Any organization can adopt internal check.	Internal audit is adopted only those concerns which really need it

1.22 PROCEDURE OF AUDIT:

The way in which the audit work should be conducted by the auditor.

1) Routine checking

2) Test checking

3) Surprise checking.

4) Audit in depth.

5) Adoption of distinctive tick mark, check mark etc…

1. Routine checking: It is the checking and casting common books of accounts by the auditor. It involves following activities.

a) Checking, casting and sub casting of such books.

b) Checking of posting into ledger book.

c) Checking the balances transferred from one book to another Common Books. Sales ledger, private ledger, wage sheet , general ledger, debit note, credit note, all subsidiary books like cash book, purchase book, journal proper etc..

Advantages of routine checking:

1) It facilitate through checking of books of original entry.

2) Posting under routine checking, posting are completely checked.

3) Thorough checking of casting and posting are involved.

4) Verifying the arithmetical accuracy in the entries.

5) Clerical errors and ordinary frauds are located through routine checking.

6) It constitutes the basis of entire audit.

7) It ensures there is no alteration of figures.

Limitations of routine checking:

1) It is purely a mechanical checking.

2) It is not important in an organization where self balancing system is in operation.

3) Simple type of errors and frauds can be located

2. Test Checking: Testing of test checking means to select and examine a representative sample from large number of similar items. The main objective of test checking is to select representative item and examining it and conclusion is drawn from all of the items.

Essentials of Test Checking:

1) The success of test checking depends upon the system of internal check in operation.

2) The sample should be selected at random.

3) Transaction should be selected only representative of the whole of the group.

4) Homogeneous transactions are taken into account.

5) Selection of sample should be made without bias.

6) Test checking is not applicable in cash book transactions.

7) No indication should be given to small organization.

8) It is not applicable to first month and last month transactions.

9) It is not applicable to checking of opening and closing balance.

10) If the transactions are non-recurring in nature it is not applicable.

Advantages:

1) Complete the audit work in a short time.

2) The volume of work of the auditor is reduced to certain extent.

3) It ensures better accuracy of the book of account if selection is made on properly.

4) It ensures examination of efficiency of the internal check system of the organization.

Limitations:

1) All of the errors and frauds cannot be detected.

2) Test checking increase the responsibility of the auditor.

3) The staff of the client may become careless.

4) The current financial position cannot be revealed.

3. Surprise checking: A system under which the auditor make surprise visit to the organization and check the important items i.e. the verification of the cash book, investment, examination of entries related to stock and stock items and examine the book of original entry.

4. Auditing in depth: Examination of selected item in depth or to the origin to conclusion. Generally it is adopted where internal control is not effective.

5. Adoption of distinctive tick mark, check mark etc: For the purpose of audit the auditor can use the ticks, tick marks, check marks etc to indicate the work done by the auditor.

1) Different type of tick should be used in different type of audit work.

2) It is better to use ballpoint pen instead of pencil.

3) Tick of different colours for different audit.

4) Tick should be too small.

5) Tick should be clear and simple.

6) Tick should not be mixed up with the figures shown in the book of account.

7) Clear instructions must be provided to the client for the use of tick mark.

8) Tick of client staff and audit staff should be distinctive.

UNIT – II

2 VOUCHING:

Vouching is the act of checking or examining the entries made in the books of account with the supporting the documentary evidences or vouchers.

In the words of .L.R DICKSEE ,"Vouching is an act of comparing entries in the books of account with the documentary evidence in support thereof".

2.1 OBJECTIVES OF VOUCHING:

1) The principal objective of vouching is to ensure that the transactions, as recorded in the books of accounts, are acceptable, genuine, properly authorised and correctly recorded.

2) Another objective of vouching is to ensure that all the entries made in the books are supported by necessary documentary evidence.

3) To see that all the transactions connected with the business have been recorded in the appropriate books of account.

4) To ensure that no transactions, which is not connected with the business, has been recorded in the books of accounts.

5) Detection of errors and frauds.

2.2 IMPORTANCE OF VOUCHING

Vouching constitutes the foundation upon which the super structure of auditing is erected. It is the back born of auditing. In the words of F.R.M De Paula, vouching is the essence of audit. Vouching can be regarded as the essence or back bone of auditing for the following reasons.

a) The success of an audit largely depends upon the care and attention with which vouching is accomplished.

b) Vouching is the most potent tool in the hands of an auditor to ascertain the accuracy of the transactions recorded in the books of account.

c) To see that all the transactions connected with the business have been recorded in the appropriate books of account.

d) To ensure that there are no transactions, which are not connected with the business, has been recorded in the books of accounts.

e) Detection of errors and frauds

f) Vouching ensures the arithmetical accuracy of the books of account.

g) If vouching is done with care and caution, the auditor can smoothly proceed further in his work.

2.3 VOUCHERS

A voucher is the documentary evidence in support of a transaction recorded in the books of account. It is a documentary evidence of an entry in a book of account. The following are the some of the examples of vouchers:

a) Receipt obtained from a payee.

b) Counter foil of a receipt.

c) Purchase invoice.

d) Sales invoice.

e) Cash memo.

f) Bank pay-in-slip.

g) A contract or an agreement.

h) A resolution passed at the meeting of the board of directors.

i) Minutes of a meeting.

j) Bought notes. k) Sold notes.

l) Debt note.

m) Credit note.

n) Wages sheet.

o) Salary register

p) Goods inward book.

q) Goods outward book.

2.3.1 Types of vouchers:

1) Primary vouchers:- a primary voucher is written evident in original. Purchase invoice, cash memos for goods purchased etc. are examples.

2) Collateral or secondary vouchers:- even evidences in original are not available, copies of the evidences are produced in support. Again, sometimes, subsidiary evidences are also provided for the purpose of audit. Such vouchers are usually known as collateral or secondary vouchers.

Essentials of vouchers or points to be noted by the auditor while vouching the vouchers:

1) Vouchers are consecutively numbered, arranged serially in the order of the entries and are properly filed.

2) Vouchers are in the name of the client.

3) See the teach voucher is genuine on its face.

4) Voucher is certified as correct by a responsible official.

5) The amount of each voucher is written in words and figures.

6) Every voucher, which is a receipt for cash payment over Rs 5000, bears a revenue stamp of Rs 1.

7) Alteration made in a voucher is properly signed by the maker and approved by a responsible official.

8) Any explanation is desired with to any voucher, the same should be noted in the audit note book.

9) Missing vouchers produced, the auditor should do,

a) Prepare a list of all such missing vouchers

b) Call for explanation from the concerned official from the loss of original vouchers

10) If any voucher requires a special scrutiny, the auditor should proceed cautiously and use special ticks for checking.

11) As far as possible the auditor should complete the vouching work relating to a particular period in continuous sitting.

12) The auditor should not take the help of any staff while vouching the vouchers.

13) Test checking may be resorted only in exceptional circumstances.

2.4 VOUCHING OF CASH BOOK OR CASH TRANSACTIONS

Cash transactions take place almost every day in business. An auditor should give care and attention to the vouching of cash transactions. The main objectives of vouching of cash transactions are,

1) To ensure that all receipts of cash are duly accounted for.

2) To ensure that no improper payments are made.

3) To see that all receipts and payments of cash are actually and properly recorded.

4) To see that all payments have been made to proper persons and the payments are true payments.

5) To see that cash and bank balance correct and really exist. Vouching of cash book or cash transaction covers the vouching of receipt side and vouching of payment side.

2.4.1 Vouching Of Receipt Side Or Debit Side Of Cashbook Or Cash Receipt Transactions:

Vouching of cash receipt transactions is more difficult than that of cash payment transactions, since there is greater chance of manipulation in regard to cash receipt. The auditor should bear in mind the following points, while vouching the cash receipt transactions.

1) The auditor should carefully examine the system of internal check in operation with regard to cash receipt transactions.

2) An auditor can resort to test checking only if he has satisfied himself that there is an efficient system of internal check.

3) He should ascertain whether a diary of cash receipt or rough cash book has been in use. If a rough cash book has been in use, he should examine the entries in the rough cash book and compare with the entries in the ash book.

4) He should examine the methods of depositing daily receipts into the bank.

5) He should check the bank pass book with the entries in the cash book.

6) He should vouch cash receipts by reference to documentary evidences.

7) He should enquire into the system of allowing documents, the rate of discount allowed etc.

8) He should enquire into the bad debts written off. He should satisfy himself the bad debt written off are authorized by a responsible person.

He should ensure whether there is a proper control over use of receipt book. In this context, he should keep in mind the following points:

a) All receipts are on printed forms.

b) See that receipt book should be consecutively numbered.

c) The receipts have to be signed by a responsible officer.

d) The unused receipt book should be kept in safe custody.

e) All spoilt receipts should remain attached to the counter foils.

2.4.2 Vouching Of The Important Items On The Debit Side Of The Cashbook Or Cash Receipt Transactions:

1) Opening balance:

The opening balance of the cash book should be vouched by comparing it with the closing balance of cash book as shown in the audited copy of the balance sheet of the previous year,

2) Cash sales:

The vouching procedure in regard to cash sales should be on the following lines:

1. He should examine the system of internal check in operation in regard to cash sales.

2. After ascertaining the efficiency of the internal check system as regards cash sales, auditor should vouch the cash sales as follows:

a) Cash memos written by the salesman should be checked with the summery sales prepared at the end of the day.

b) He should examine the rough cash book, if any.

c) He should check up the rough cash book with the main cash book.

d) The summaries of daily sales should be checked with the entries in the stock register.

e) He should verify the daily deposit of cash received into the bank, pay-inslip also should be vouched.

3) Receipts from debtors:

While vouching the receipts from debtors, an auditor should bear in mind the following points:

1. He should enquire into the system of internal check in operation in regard to the receipt from debtors.

2. After satisfying himself about the efficiency of internal check in operation in regard to the receipt from the debtors, the auditor should conduct the vouching of receipts on the debtors on the following lines:

a) He should check the total cash received from the debtors by verifying the rough cash book with the counter foils of the receipts issued to customers.

b) He should check the cash book with the rough cash book.

c) He should check the details of cash and cheques paid into the bank.

d) He should enquire into whether bad debts are written off by a competent authority.

e) He should verify the balances due as per the schedule of debtors with letters of confirmation received.

f) He should be alert to the possibility of teeming and lading.

4) Receipts from bills receivable:

Bills receivable include bills of exchange, promissory notes, and I.O.U's received from debtors. The receipts from bills receivable can be in two ways:

1). Receipts from bills discounted: The vouching of receipts from bills discounted should be as follows:

a) The amount of cash received from bills discounted should be checked by comparing the bills discounted book with the cash book, pass book, B/R book.

b) See that proper records have been made in the books for discount on bills discounted.

c) He should determine the contingent liability in respect of bills discounted but not matured on the date of the balance sheet.

2). Receipts from bills matured

a) The auditor should check the cash received from bills matured by comparing the bills receivable book with the cash book and the pass book.

b) Special attention should be given to bills which have matured but remain unpaid.

5) Receipts from sale of investment:

Vouching of receipts from the sale of investment should be on the following lines:

a) Investments are usually sold through brokers, as such, broker's sold notes or contract notes should be examined to vouch the amount from the sale of investments. If the sale of investment has been effected through the bank, then, the bank advice should be examines to vouch the amount received from the sale of investments.

b) The sale proceeds of the investments should also be checked with the related investment account with the stock market quotations.

c) If the investment has been sold cum-dividend, the auditor should see that the sale proceeds are properly apportioned between capital and revenue receipt.

d) If the investment has been sold ex dividend, the auditor should see that the dividend is received and recorded.

e) He should see that the profit or loss on the sale of investment is properly adjusted.

f) If the investments are pertain to some ear marked funds, the auditor should see that the profit or loss on the sale is transferred to the ear marked fund a/c.

6) Receipt from the sale of fixed assets:

Vouching of receipts from the sale of fixed assets should be on the following lines:

a) The auditor should see that the sale of fixed asset is properly sanctioned.

b) If the sale of fixed assets is through a broker, the proceeds of the fixed assets sold should be vouched with the help of sold notes. In the case of sale of fixed assets is through an auctioneer, the sale proceeds should be vouched with the help of the auctioneer's note. He can verify the cash receipt in the cash book with the counter foil or carbon copy of the receipt issued to the party. He may also vouch the sale proceeds of fixed assets with the correspondence with the parties and the sale contracts and the fixed asset a/c.

c) He should see that proper fixed asset a/c has been credited with the sale proceeds.

d) If there is any profit, the auditor should see that it is credited to capital reserve.

e) In the case of certain prepaid expenses in respect of fixed assets, the auditor should check whether suitable adjustments are made in the expenses accounts.

7). Loan received:

Vouching of loan received should be on the following lines:

a) He should ascertain that whether client is empowered to borrow money.

b) In the case of a joint stock company, he should verify whether the legal provisions have been complied with.

c) He should verify the loan agreement to ascertain the terms and conditions on which the loan has been received.

d) If the loan is secured, he should ascertain what security has been offered and the value of security offered.

e) He should ensure that the loan amount received is recorded in the books of account.

f) If the interest on loan is unpaid, the auditor should see that it is properly adjusted.

8). Dividend on investment:

a) The auditor should verify the dividend received is recorded in the cash book with the counter foils of the dividend warrants.

b) To see that dividends have been received in the dates.

c) If the dividend is sold ex-dividend, see that dividends are subsequently received are entered in the cash book and credited to dividend account.

9). Subscription received

10). Insurance claim received

11). Commission received

12). Rent received

13). Royalty received

2.4.3 Vouching Of Cash Payments Or Credit Side Of The Cash Book:

While vouching cash payments, an auditor should pay attention to the following points.

1) All vouchers relating to cash payments should be serially numbered and properly arranged.

2) He should insist that the vouchers are properly dated.

3) He should evaluate the system of internal check in operation with regard to cash payments and satisfy himself as to the efficiency of the internal check.

4) He should see that:

a) The cash payments are for the purpose of the business.

b) Payments are related to the period under audit.

c) The payments is properly sanctioned or authorized.

d) The payments are made to the right person.

e) The payments are supported by proper vouchers.

f) The payments are properly recorded in the cash book.

5). Examine the rough cash book items and compare it with the main cash book.

6) See that the payments made are posted to the concerned accounts.

7) See that the amount appears in the vouchers both in words and figures and it agrees with the amount in the cash book.

8) Ensure that the payments have been passed as correct by a responsible official.

2.4.4 Vouching Of Different Items On The Payment Side Or Credit Side Of The Cash Book :

1) Opening credit balance:

The opening credit balance in the bank column can be verified from the previous year's audited balance sheet.

2)Cash purchases:

The vouching of the cash purchases should be on the following lines.

1) The auditor should examine entries in the cash book with the help of cash memos or invoices issued by the supplier and also goods inward book.

2) Special attention should be paid to trade discount, which should be deducted from purchase.

3) See that the cash paid for the goods have actually received.

4) He should see that the purchases are duly authorised.

5) He should see that the amount paid is debited to the appropriate account.

6) To ascertain whether payment made for cash purchases relates to the business.

3) Payments to creditors

Vouching of payment to creditors should be on the following lines.

1) Payments to creditors may be vouched with the receipts issued by the creditors.

2) He should check the amount due to the creditors with the accounts of the creditors.

3) Examine the goods inward book and see that goods have actually been received.

4) The auditor should verify the periodical statement of accounts.

5) In the case of purchase made before the close of the year, see that goods not actually received are kept out of the closing stock of the year.

4) Payment of bills payable

Payment of bills payable on their maturity should be vouched on the following lines.

1) The payment of bills payable, as recorded in the cash book, should be vouched with the bills payable book and also with the bills payable returned by the payees.

2) If the bills payable are through the bank, the auditor should examine the bank pass book for the payment.

3) He should see that bills payable paid and returned by the payees are cancelled.

5) Vouching of loans advanced

Loans advanced should be vouched by the auditor on the following lines.

1) He should see that loans advanced are properly authorised.

2) He should examine the loan agreement.

3) He should vouch the loan advanced as recorded in the cash book with the loan agreement also with the receipt given by the borrower.

4) If the loan is advanced against any security, the auditor should examine the security and its title deeds.

5) Examine the mortgage deed, if the loan is advanced against mortgage.

6) See that the provisions of the companies Act as regards the granting of loans to directors and officers of the company are complied with.

6) Purchase of investment

Vouching of purchase of investment should be on the following lines.

1) The auditor should see that the purchase of investment is properly authorised.

2) If the investments are purchased through a broker, he should vouch the investments purchased with the broker's note.

3) If the investments are purchased through the bank, he should examine the bank pass book to check the payment.

4) He should make a physical verification of the investment purchased.

5) If the investments are purchased cum interest, he should see that the payment made is properly allocated between capital and revenue.

6) See that investments purchased are registered in the name of the client.

7) In the case of accompany, the auditor should see that investments have been purchased in accordance with the provisions of the companies Act.

7) Payment of capital expenditure

The payment of capital expenditure refers to the payment made for the acquisition of the fixed assets such as land & building, plant & machinery, patent, copy right, furniture etc. Vouching of payment of capital expenditure should be on the following lines.

1) The auditor should see that the payment of capital expenditure is properly authorised.

2) He should examine the document pertaining to the purchase and ownership of the fixed assets.

3) He should examine the invoices and the receipts obtained from the suppliers to ensure that payments have been made.

4) He should see that all expenses incurred for the acquisition are capitalised.

5) He should see that repairs and maintenance expenses incurred are charged to revenue account.

6) He should physically examine the fixed assets purchased.

7) He should vouch the cash boom entries for the payment of capital expenditure with the concerned ledger account.

8) See that property purchased is registered in the name of the client.

2.4.5 Vouching Of Payment Made For The Acquisition Of Patents:

Vouching of payments made for the acquisition of patents should be on the following lines.

1) If the patent has been purchased, the auditor should vouch the payment made for the patent with the help of the contract for sale and the receipts for the payment obtained from the seller.

2) If the patent has been purchased through an agent, the auditor should vouch the agent commission with the help of agents account and receipt given by the agent. He should see that the agent's commission is capitalized.

3) He should see that expenses incurred on the purchase of the patent are capitalized.

4) Where the patent is acquired through research, the auditor should see that all the expenses incurred on the experiments and the research connected with patents are capitalized.

5) He should see that payments made towards the renewal fee are charged to revenue account.

6) He should actually see the patent.

2.4.6 Vouching Of Wages:

The object of vouching wages is to ensure that the payment for wages as recorded in wage sheet and cash book, were actually made properly authorised and were correctly maintained. Vouching of payment of wages should be done in the following lines.

1) He should enquire into the system of internal check in force in regard to the maintenance of wage records, preparation of wage sheet and payment of wages.

2) If the internal check is effective, the auditor can conduct the vouching of wages on the following lines.

a) He should check a few items of wage sheets here and there to ensure that the calculations are correct.

b) He should check totals of wage sheet with the cash book.

c) He should see that the amount of cheque drawn for wages tallies with the totals of wage sheet.

d) He should see that deduction from wages have properly adjusted and recorded in the books.

e) He should see that wages recorded in the cash book have actually been paid.

f) He should examine the system of employment of casual labour and check the payment made to casual labour.

g) He should see that proper record is maintained for unpaid wages.

h) Wages for the current months should be compared with the wages of the previous month. If there is a material difference, the auditor should enquire into the reason for the difference.

2.4.7 Vouching Of Salaries:

Vouching of payment made for salary should be on the following lines.

1) An auditor should enquire into the system of internal check in operation in the concern in regard to the payment of salaries.

2) If the internal check system in regard to the payment of salaries is sound, an auditor can conduct the vouching of salaries on the following lines.

a) He should see that the salary bill is prepared with the sanction of a responsible officer.

b) He should see that the salary register is duly signed by each employee and counter signed by a responsible official.

c) He should check the salary register with the entries in the cash book.

d) He should see that the deduction for provident fund, life insurance premium, income tax etc have been correctly made and properly recorded in the books.

e) For vouching salaries of the secretary, manager and other important officials, the auditor should examine the board's minutes book.

f) He should check the attendance register.

g) He should compare the salary bill for the current month with the salary bill of the previous month. If there is any material difference, enquire into the reason for the difference.

h) He should see that the total of the salary book for a particular month agrees with the cheque drawn for salaries.

2.4.8 Vouching Of Petty Cash Book:

Vouching of petty cash book should be on the following lines.

1) He should examine the system of internal check in force in the business in regard to the petty cash transactions.

2) If he finds that the system of internal check is sound, he should adopt the following lines.

a) He should find out find out the system of petty cash book.

b) He should ascertain the name of the petty cashier to the amount of the imprest.

c) He should check some petty cash payments at random with the vouchers to ensure the correctness of the petty cash payments.

d) He should see that all petty cash payments over a certain amount are supported by proper vouchers.

e) He should see that petty cash payments not supported by proper vouchers are supported by slips by the officer who have spent the amounts.

f) See that the petty cash book is periodically checked and initiated by some responsible officer.

g) See that the petty cash balance as shown in the petty cash book agrees with petty cash balance as shown by petty cash account.

h) He should check the casting of total payment column and the individual expenses column.

i) He should physically count the petty cash balances on the balance sheet date. If he fails to do so, he will be held liable for damages. This was upheld in the case of London Oil Storage Company Limited v/s Sears Hasluck and Company.

j) He should see that I.O.Us are not included in the petty cash balances.

2.4.9 Vouching Of Trading Transactions:

Vouching of trading transaction is concerned with credit purchases, credit sales, purchase returns, and sales returns are entered in the purchase book, sales book, purchase return book and sales return book respectively. So vouching of trading transactions also means that vouching of purchase book, sales book, purchase return book, and sales return book. One main object of vouching of trading transaction is to detect misappropriation of goods, if any.

2.4.10 Vouching Of Credit Purchases Or Vouching Of Purchase Book:

The main objective of vouching of purchase book or credit purchases is to ensure that all purchase invoices are entered in purchase book, that goods entered in the purchase book are actually received and the business pays only for those goods which are delivered by the suppliers.

Firstly, an auditor should examine the system of internal check in force in the business in regard to credit purchases. If the system of internal check is not sound, he should check all the entries in the purchase book in detail. If the system of internal check is sound, he need not check all the entries in the purchase book in detail. He has to vouch the credit purchases on the following lines:

1) He should examine the inward invoices from which entries are made in the purchase book. While examining an inward invoice, an auditor should pay attention to the following points:

a) The invoice is in the name of the client.

b) The date given in the invoice relate to the period under audit.

c) The invoice is related to the business in which the concern deals.

d) The invoice is initiated by a responsible officer.

e) The trade discount has been deducted from the amount of invoice and then only net amount has been entered.

f) Quantity mentioned in the purchase invoice tallies with the quantity recorded in the purchase book.

2) He should check the purchase invoices with the purchase book, where the credit purchases are recorded.

3) He should see that only credit purchases are recorded in the purchase book.

4) He should see that purchases not made for the business are not recorded in the purchase book.

5) He should see that purchases of capitals assets are not included in the purchase book.

6) He should see that all goods received prior to the date of closing and taken into stock are recorded in the purchase book.

7) He should see that goods entered in the purchase book but not received are included in the closing stock.

8) He should verify some of the purchase invoices with the goods inward book, stock records and the challans from the suppliers to see that the goods have actually received.

9) He should compare some of the entries in the purchase book with the order book and goods inward book to ensure that no fictitious purchases are recorded and no invoice is entered twice.

10) To ensure that all invoices are included in the purchase book, the auditor should obtain the statement of accounts from the creditors and examine them.

11) He should make a list of all invoices missing or not available.

12) Where contracts for forward purchases are entered into, the auditor should see that they are not abnormal. If they are abnormal in amount, he should see that it is mentioned in the balance sheet by way of note.

13) He should check the casts and carry forwards to the purchase book.

14) He should check the postings from the purchase book to the purchase account as well as to the creditors account.

15) He should check carefully the purchase made in the first month and the last month of the accounting year, because, sometimes, purchases made in the last month of the last year may be included in the purchase of the current year or purchase made in the last month of the current year may be included in the purchases of the first month of next year.

2.4.11 Vouching Of Credit Sales Or Vouching Of Sales Book:

Outward invoices, which are the vouchers for the credit sales, are not completely reliable, as they are prepared by the staff of the business. So an auditor has to very careful in vouching credit sales. Firstly he should examine the following lines:

1) He should examine the outward invoices from which entries are made in the sales book. While examining the outward invoices, he should pay attention to the following points:

a) See that name of the customer stated in the outward invoice agrees with the entry in the sales book.

b) The date given in the outward invoice relate to the period under audit.

c) The invoice is initiated by a responsible officer.

d) See that trade discount allowed is deducted from the sales price and net amount has been entered.

2) He should check the outward invoices with the sales book, where the credit sales are recorded.

3) He should check the sales book with the order received book and see that the sales are genuine and all the sales are included in the sales book.

4) After the examination of outward invoices, the auditor should see that they are cancelled by stamping out and all the cancelled invoices are kept together for verification.

5) He should see that only credit sales are recorded in the sales book.

6) He should see that sales of capital assets are not included in the sales book.

7) See that good sent on sales or return or on consignment are not entered in the sales book.

8) He should see that good sold, but not delivered are not included in the closing stock.

9) He should check the casts and carry forwards of the sales book.

10) He should check the postings from the sales book to the sales account and customer accounts in the ledger.

11) He should check carefully the sales made in the first month and the last month of the accounting year, because, sometimes, sales made in the last month of the last year may be included in the sale of the current year or sale made in the last month of the current year may be included in the sales of the first month of next year.

12) If the trade discount allowed during the current year is exceptionally high, the auditor should enquire in to the reasons for the same.

13) Where the sales are subject to sales tax, the auditor should see that the sales tax collected is separated from the sales price, and is shown in a separate column in the sales book.

14) Sometimes, fictitious sales are included in the sales book to inflate the sales and the gross profit, an auditor has to take necessary steps to discover such fictitious sales.

2.4.12 Vouching Purchase Returns Or Purchase Returns Book:

An auditor should undertake vouching of purchase returns on the following lines:

1) He should enquire into the system of recording of purchase returns.

2) He should vouch the purchases returns book with the credit notes received from the creditors.

3) He should examine the goods outward book and the related correspondence to ensure that there is no suppression of purchase returns.

4) He should check the casts and carry forwards of purchase returns book.

5) He should check the postings from the purchase returns book to the purchase returns account and customers account in the ledger.

6) He should check carefully the entries in the purchase returns book for the first month and for the last month of the year to ensure that there is no manipulation of accounts.

2.4.13 Vouching Of Sales Returns Or Sales Returns Book:

1) He should enquire into the system of recording sales returns.

2) He should vouch the sales returns book with the credit notes issued.

3) He should examine the goods inward book and the related correspondence to ensure that there is no suppression of sales returns.

4) He should check the casts and carry forwards of sales returns book.

5) He should check the postings from the sales returns book to the sales returns account and customers account in the ledger.

6) He should check carefully the entries in the sales returns book for the first month and for the last month of the year to ensure that there is no manipulation of accounts.

2.4.14 Vouching Of Journal Proper:

Journal proper is meant for recording all those transactions which cannot be recorded in the other subsidiary books viz purchase book, sales book, purchase return book, sales return book, cash book, B/R book, B/P book. The following entries are recorded in the journal proper:

1) Adjusting entries.

2) Transfer entries.

3) Closing entries.

4) Rectification entries.

5) Entries for purchase and sale of assets on credit.

6) Opening entries.

7) Entries for consignment.

8) Entries for application for shares, allotment on shares and calls on shares.

An auditor should vouch the journal proper on the following lines:

1) He should see that every entry in the journal proper is supported by a voucher or evidence.

2) He should see that every entry in the journal proper is explained by narration.

3) When the evidences are not available for some entries in the journal proper, the auditor should check those entries from the evidence of parties.

2.5 VERIFICATION OF ASSETS AND LIABILITIES

Verification means 'proving the truth' or 'confirmation of the truth'. Verification of assets and liabilities means proving the truth about the existence and the correctness of the money value of the assets and liabilities appearing in the balance sheet of the business. In other words, it means establishing the actual existence of the assets and liabilities appearing the balance sheet, ownership and possession of the assets and proper classification and valuation of assets and liabilities.

2.5.1 Objects of verification of assets and liabilities:

1) To find out whether assets and liabilities shown in the balance sheet actually exist.

2) To ascertain whether the assets and liabilities appearing in the balance sheet are shown at their correct values.

3) To confirm the possession and ownership of the assets appearing in the balance sheet.

4) To find out whether there is proper classification of assets and liabilities.

5) To check the arithmetical accuracy of the books of accounts.

6) To ascertain whether the balance sheet gives a true and faire view of the financial position of the business.

2.5.2 Difference between vouching and verification:

1) Nature:- vouching is the examination of the business transactions recorded in the books of original entry, where as verification is the examination of assets and liabilities appearing in the balance sheet.

2) Objectives:- vouching is done to examine the correctness and the authenticity of the business transactions recorded in the books of original entry. But verification is undertaken to confirm the values of assets and liabilities of the business as shown in the balance sheet.

3) Work begins:- verification of assets and liabilities are undertaken after the vouching of the books of accounts. In other word, verification begins where vouching ends.

4) Time:- vouching is done throughout the year, whereas verification is done at the end of the year after the balance sheet is prepared.

5) Scope:- vouching does not include valuation of assets. But verification of assets includes the valuation of assets.

6) Utility:- vouching of books would only indicate that a particular assets or liabilities ought to exist. It does not indicate whether a particular assets or liabilities really exist at the date of the balance sheet. But verification proves whether the assets or liabilities really exist at the date of the balance sheet.

7) Basis: -vouching is based on documentary examination. On the other hand verification is based on physical as well as documentary examination

8) Personnel:- vouching is done by the staff of the auditor. But verification is done mostly by the auditor himself.

2.6 VALUATION OF ASSETS

Valuation of assets means the determination of or the ascertainment of the money value at which the assets are shown in the balance sheet. However in audit it implies critical examination and testing of the determined values of the assets on the basis of generally accepted accounting principles. In short, it is the process of ensuring that the money value of the asset as shown in the balance sheet has been properly determined.

2.6.1 Objectives:

1) To verify whether the assets shown in the balance sheet have been properly valued.

2) To indicate that the balance sheet represents a true and fair view of the financial position of the business.

3) To indicate that there is no manipulation of account to inflate or reduce the profit.

2.6.2 Auditors Duty In Regard To Valuation Of Assets:

Valuation of assets is a difficult task. It requires technical knowledge. But an auditor has neither technical knowledge nor the time required for the valuation of assets. So an auditor can't be expected to do the valuation of assets. In short an auditor is not a valuer. The valuation of assets is done by the officials of the business. Auditor has only to make an enquiry into the valuation of assets and satisfy himself that the value of assets are properly determined. This view was upheld in many cases. For example, the Kingston Cotton Mills company's case, it was held, it is no part of an auditor's duty to take stock. He must rely on other people for the details of the stock.

An auditor has to critically examine the valuation and satisfy himself that valuation of assets has been properly made to satisfy himself that the values of assets are correct, an auditor should do the following:

1) He should obtain all information available in respect of the valuation of assets.

2) He should critically examine and analyze the all figures of the valuation of assets.

3) He should verify whether the principles and practice of valuation of assets have been consistent from year to year.

4) He should verify whether the value of assets have been determined properly in accordance with the generally accepted accounting principles.

5) Wherever necessary he should take the assistance of technical experts for valuing the assets.

6) He should ascertain whether current values of assets are fair and reasonable.

If the auditor does not exercise proper care and skill in the matter of enquiry into the valuation of assets. He will be held guilty of negligent or fraud. This was upheld in many cases

For example, in the case of Lease Estate Building & investment v/s shepherd, the auditor was held liable for the dividend paid out of the capital for several years, based on the wrong financial statement.

2.6.3 Classification Of Assets/Types Of Assets For The Purpose Of Valuation & Mode Of Valuation:

1) Fixed Assets

They are acquired for permanent use in the business. It is not for resale in the ordinary course of business but for the purpose of enabling the business to earn profit. These assets will be in use for a pretty long period. Examples are land, building, plant, machinery, etc. Fixed assets are to be valued at original or historical cost less total depreciation written off(Going concern value).

2) Current assets (circulating or floating assets)

Current assets are those assets, which are acquired for resale or produced for the purpose of sale or converting them in to cash. Examples are stock, semi-finished goods, book debts, cash and bank balance, etc...... Cash and bank balance- no valuation required Book debts and bills receivable- valued at book value Raw materials- first in first out or last in first out or average cost method Closing stock-at cost price or market price whichever is lower.

3) Intangible assets

Intangible assets are those assets, which cannot be seen or touched. Examples are good will, copy rights, patent etc. these assets are shown at cost price.

4) Wasting assets

Wasting assets are of fixed nature, which are depleted gradually or exhausted in the process of earning income. Examples are mines, quarries, oil wells etc. These assets are valued at original cost less provision for depletion.

5) Fictitious assets

These are neither physically visible nor realizable into cash. They are revenue expenditure that have been temporarily capitalized with the object of generating the amount over a period of years the benefit of which accrues. Examples are preliminary expenses, discount on issue of shares, advertisement suspense account etc.

6) Contingent assets

These are assets the existence, values and ownership of which depends up on the occurrence of a specified event. Examples are claim for refund of income tax, sales tax.

Various values used for valuation.

1) Cost price.

2) Market price.

3) Replacement.

4) Realized value.

5) Book value.

6) Breakup value.

7) Going concern value.

2.6.4 DIFFERENCE BETWEEN VERIFICATION AND VALUATION NATURE

In verification of assets, an auditor verify not only the actual existence of the assets but also their proper valuation . But in the case of valuation of assets, an auditor has to merely ensure that the values of the assets as shown in the balance sheet is correct.

1) Scope: - Verification includes valuation also. Valuation is a part of verification of assets.

2) Work begins: - Verification of assets comes in before the valuation of assets but valuation of assets follows verification of assets.

3) Responsibility: - In the case of verification of assets , the auditor is entirely responsible for the work. But in the case of valuation of assets is done by the owners. The auditor merely ensures that the values of the assets as shown in the balance sheet are correct.

4) Guarantee: - In the case of verification of assets, the auditor gives guarantee that the assets have been properly verified. But in the case of valuation of assets he does not give any guarantee.

5) Basis : -Verification of assets can be made by an auditor on the basis of physical inspection as well as documentary evidences. But for valuation of assets, he depends up on the estimates of the proprietor.

6) Chance of fraud : -In verification of assets, the chances of manipulation of accounts to inflate or deflate profit is less, but in valuation of assets, there is more chance of such frauds.

2.6.5 Classification Of Liabilities For Valuation:

Current liabilities

Current liabilities are those liabilities of the business, which are short-term liabilities. They are to be settled within a period of one year. Examples are trade creditors, bills payable, outstanding expenses.

Fixed liabilities

These are of long-term nature. Examples are long term loans borrowed, long term deposit received.

Contingent liability

It is not an actual liability. It may become a liability on the happening or nonhappening of certain events in future. In short it is a liability which may or may not arise in the future for payment. Examples are liabilities in respect of bills discounted, guarantee given, compensation pending.

2.7 VERIFICATION AND VALUATION OF DIFFERENT ASSETS

1)Freehold property

Freehold property refers to the land and building which is absolutely the property of the business. While undertaking the verification and valuation of freehold property an auditor should observe the following points:

1) Examine the title deeds: He should examine the title deed relating to freehold land& building to ensure that they are in the name of the client. If there is any doubt relating to title of property, he should consult solicitors of the client.

2) Examine the conveyance or brokers account: If the freehold property has been purchased, he should examine the correspondence, conveyance deed and broker's or auctioneer's account If the freehold property is consist of building constructed by the client the auditor should ask for and examine the architect's and the builder's certificates.

3) Capitalization of expenses: He should see that if legal expenses, brokerage and other expenses are incurred for the acquisition of freehold property, they are capitalized.

4) Mortgage of freehold property: If the freehold property mortgaged, auditor should get a certificate from mortgagee stating that the title deed are in his possession He should also make proper enquiry to ensure that there is no second mortgage on the freehold property If the title deeds of the freehold property are with a bank or solicitors for safe custody the auditor should get a certificate from the bank or the solicitor stating that they are held by him for safe custody and not as a security for any loan.

5) Additions to free hold property: He should check additions to the freehold property, if any, made during the year with the help of relevant vouchers. He should also see that the cost of additions is capitalized.

6) Sale of freehold property: If any freehold property sold during the year, an auditor should check such sales and see that profit or loss thereon is correctly dealt within the accounts.

7) Repairs and renewals: He should see that repairs and renewals of freehold property are charged to revenue account.

8) Provision for depreciation: He should examine the adequacy of provision for depreciation on free hold building.

9) Appreciation of freehold building: If any appreciation of freehold building is taken into account, the auditor should see that appreciated value is clearly disclosed in the balance sheet. He should also obtain a certified copy of valuation of the property from a professional valuer.

10) Shown in the balance sheet: See that the freehold property are shown separately in the balance sheet under the head fixed asset He should also see that freehold property are shown cost less depreciation In case freehold property is shown in the balance sheet in market value, the auditor must see that they are clearly mentioned in the balance sheet.

2) Leasehold property

Lease hold property refers to land and building acquired by a business for a fixed period on lease. While undertaking the verification and valuation of lease hold property an auditor should observe the following points.

1) Examine the lease deed: He should examine the lease deed to ascertain the cost of leasehold property, the duration of the lease, terms and condition of the lease.

2) Registered: If the lease is for more than one year the auditor should see that the lease deed is registered.

3) Amount capitalized: He should see that amount paid for lease property is capitalized.

4) Examine the receipt for the lease: He should see that the lease rent is paid regularly and lease is existing. For this purpose he should examine the last receipt of the payment of rent.

5) Examine the agreement with subtenant: He should see that the agreement with the subtenant is if it is sublet to others.

6) Addition to lease hold property: Verified with relevant vouchers that see that amount paid is capitalized.

7) Repairs and Renewals: See that it is charged to revenue.

8) Provision for depreciation

9) Shown in the balance sheet

3) Plant and machinery

While undertaking the verification and valuation of plant and machinery an auditor should observe the following points.

1) Examine the plant register: He should examine the plant register if it is maintained by concern.

2) Examine the schedule of plant and machinery: He should call for and examine the schedule of plant and machinery signed by the engineer.

3) Verify the plant and machinery purchased: He should verify the plant and machinery verified, plant and machinery purchased with the original invoice ———————————— and agreement with the ventures.

4) Check the plant register with plant and machinery account: To ensure plant and machinery account and satisfy himself as to the value of plant and machinery.

5) Addition to the plant machinery

6) Sale and plant and machinery

7) Repairs and renewals

8) Provision for depreciation

9) Shown in the balance sheet

4) Furniture and fixtures

While undertaking the verification and valuation of furniture and fixtures an auditor should observe the following points.

1) Examine furniture stock register

2) Verify the price of furniture purchased with invoices and receipts

3) Physical verification He should verify the physical existence of furniture by personal inspection.

4) Addition to the furniture and fixture

5) Sale of furniture and fixtures

6) Provision for depreciation

7) Method of depreciation: He should enquire into the method of depreciation as the amount on depreciation depends upon the use of the asset and the method of depreciation adopted.

8) Unserviceable furniture written off: He should see that the unserviceable furniture and fixtures are written off under proper authority.

9) Shown in the balance sheet

4) Valuation of goodwill

Goodwill is the value of reputation of an organization which enables the business to earn more than the normal rate of profit. While under taking verification and valuation of goodwill an auditor should observe the following points;

1) Goodwill purchased along with running business: When goodwill has been purchased along with running business from some vendors the amount of goodwill should be verified by the auditors from the purchase agreement with vendors, showing the price paid for the goodwill. Where the price paid for the goodwill is not specifically fixed, auditor should ensure that the amount of goodwill taken into account is the amount of purchase consideration, i.e, amount of purchase consideration over net assets taken over.

2) Goodwill arise by writing up the value of assets: When goodwill account has been arise by a company by writing up the value of its assets or the revaluation of assets, the auditor should examine the basis on which assets have been revalued and satisfy himself that the amount of goodwill brought into account is proper.

3) Goodwill created in the books of partnership firm: The amount of goodwill created in the book of partnership firm on the admission of a new partner or on the retirement or on death of an existing partner, should be verified by the auditor with the help of with the help of the partnership deed. The auditor can also verify the changes made in the goodwill account from time to time on the basis of the provisions of the partnership deed.

4) Valuation of goodwill: Valuation of goodwill is a matter of financial policy, to be decided by the management of the business. The auditor can't interfere in the valuation of goodwill, though he may give his advise on the valuation of goodwill. For the valuation of goodwill the auditor is just to see that the goodwill is shown in the balance sheet at its proper value.

5) Insist upon writing off goodwill: If it appears to him that the future benefit associated with the goodwill does not exist, he should insist on writing off the goodwill.

6) Shown in the balance sheet: An auditor should see that goodwill valued at cost less amount written off and shown in the balance sheet.

7) Verification and valuation of patent right

1) Examine the schedule or list of patent right.

2) Verify the patent right with the help of certificates of patents.

3) Ensure that the patents have registered in the name of the client.

4) Patent right are developed by the research work: If the patent right are developed by concern by doing some research work, the cost of research and development should be capitalized. Similarly if the patent right have been purchased, the cost of purchases of patent should be capitalized.

5) Renewal fee should be charged to revenue.

6) Cost of patent written off An auditor should see that the cost of patent written off. If a patent becomes obsolete, the entire book value should be written off.

7) Shown in the balance sheet. See that the patents are shown in balance sheet

8) Verification of investment

1) Examine the schedule of investment: He should call for and examine the schedule of investment held by the client with reference to the relevant ledger accounts.

2) Physical verification: If investment is in the hand of the client, auditor should verify the existence of the investment by personal inspection. If it is entrust to a bank for safe custody, he should get a certificate from the bank, giving the details of the security in its hand and stating that they are free from any charge. If an investment is held by a trustee on behalf of the company, the auditor should call for and examine the trust deed. If the securities are held by the client brokers, the auditor should call for securities for personal inspection. If the securities deposited with bank or any other creditor as a security towards loans borrowed, an auditor should get a certificate from bank or creditor to this effect.

3) Purchase of investment: If securities are purchased during the year, he should verify the purchase by examining the certificate. If no certificate is available he should examine purchase with the help of transfer deed and broker's bought note.

4) Transfer fee, stamp duty etc.: He should see that transfer fee, stamp duty etc incurred on the purchase of investment are properly capitalized.

5) Sale of investment: If the securities are sold during the year, the auditor verify the sale price with the help of broker's sold note. See that the sale is approved by board of directors. See that whether the profit or loss made on sale is properly adjusted in the accounts.

6) Registered in the name of the client: He should ensure that the investment is registered in the name of the client and they are free from charges other than those disclosed.

7) Properly valued Satisfy himself that investment is properly valued.

8) Shown in balance sheet: See that the investments are shown in balance sheet at market or cost price

9) Verification of cash in hand

1) Physically count the cash in hand: The auditor should actually count the cash in hand by attending the business premise on the last day of the financial year. Actual verification of cash in hand has been considered to be the most important part of an auditor's duty. It was upheld in many cases. For instance, London oil storage company ltd v/s Secer Husluck & co. In this case it was held that the auditor has committed a breach of duty in verifying the existence of the pretty cash balance.

2) Surprise visit to business premises: To prevent manipulations & fraud the auditor can pay a surprise visit to the business premises of the client.

3) Count different kinds of cash balances simultaneously: If there are different kinds of cash balances say petty cash in hand and cash in hand, the auditor should count them simultaneously. Shortage on one account may not be made up from another account.

4) Count currency notes, coins, stamps and I.O.Us: He should count on closing date not only currency notes and coins but also the stamp and I.O.Us in hand, as they are also part of cash balance.

5) See that I.O.Us are genuine.

6) Physically count the stock of the unsold canteen tickets, lunch coupons etc as they are likely to be converted into cash.

7) Compare the cash in hand as revealed by physical counting with the cash balance as shown by the cash flow.

8) Verify cash transactions with the proper documentary evidences and correspondence.

9) Shown in the balance sheet.

10) Verification of cash at bank

1) Compare bank balance as shown by the cash book with the bank balance as shown by the bank pass book.

2) Preparation of bank reconciliation statements If there is some difference between these two balances, he should prepare a bank reconciliation statement.

3) Obtain separate certificate for fixed deposit account, savings bank account, current account etc... He should obtain separate certificate from the bank to verify balances of the different types of bank accounts.

4) Verify all of the bank accounts individually In case there are accounts with more than one bank the auditor should verify them individually.

5) See that necessary adjustments are made in respect of interest accrued on fixed deposit.

6) See that Cheques not yet collected are genuine.

7) In case money is kept with other agencies, the nature of interest and the name of the agencies should be disclosed by the auditor in his audit report.

8) Where large amounts are held in foreign banks, the fact should be disclosed by the auditor in his audit report.

9) Shown in the balance sheet

11) Verification of bills receivable

1) Examine each bill in hand to ensure that it is properly drawn, sufficiently stamped and duly accepted by the accepter.

2) Verify the bills receivable given in the balance sheet by obtaining certified schedule of bills in hand.

3) Compare the schedule of bills in hand with bills receivable book and bills receivable account.

4) See that overdue bills are not included in the bills in hand.

5) Bills discounted should be examined by referring the cash book and pass book.

6) See that bills discounted or endorsed but not yet met are treated as a contingent liability and are indicated by way of foot note in the balance sheet.

7) See that proper provisions are made for contingent liability on bills discounted.

8) Shown in the balance sheet

12) Verification of debtors

1) Examine the schedule of debtors.

2) Verify the schedule of debtors with the help of sales ledger or debtor's ledger.

3) Verify the sales ledger balances with the help of sales book, sales returns book, cash book etc.

4) See that the book debt shown in the balance sheet is recoverable.

5) Obtain a certificate from a responsible officer in respect of statement of book debt.

6) See that adequate provisions are made against book debt. The adequacy of the provisions for the bad & doubt full debt made by the management can be checked by the auditor by considering the following points,

? Age of debt

? Regular payment

? Heavy dishonoured bills

? Comparison of actual bad debt with budgeted bad debt

7) See that proper provision is made for discount on debtors.

8) In case, where certain amounts of debts are written off, the auditor should enquire into the details.

9) Debts due from subsidiary company should be carefully inspected by the auditor.

10) In case of debt in a foreign company, the auditor should find out, by converting the amount into home currency.

11) In case the client is a company, the auditor should see that the book debts are classified for balance sheet purpose as required by the companies Act 1956. That is book debts are classifies as follows,

- Debts considered good in respect of the company is fully secured.
- Debts considered good for which the company holds no security other than the debtor's personal security.
- Debt considered doubt full.

Further debt due by directors or officials of the company either severally or jointly with any other person shown separately.

Again debt due from other company under the same management should be disclosed with the names of the companies.

13)Verification of loans advanced:

Generally loans advanced will be of the following types:

1) Loans against the security of land & building.

2) Loans against the security of stock & shares.

3) Loans against the security of goods.

4) Loans against the security of life policies.

5) Loans against the security of guaranty of a third party.

6) Loans against the personal security of the borrower.

While verifying the loan advanced, an auditor should keep in mind the following points:

1) Examine the schedule of loans granted.

2) Verify the loans advanced with the help of loan agreement, application of loans, acknowledgements of receipts, and loan account in the ledger.

3) Examine the authority of person granting the loans. Ensure that the loans advanced are within the powers of the person granting the loans.

4) Ascertain the worth of the securities In the case of secured loans, the auditor should ascertain the worth of securities offered and see that sufficient margin is maintained.

5) Examine the credit worthiness of the borrower In the case of unsecured loans, the auditor should examine the credit worthiness of the borrower and ascertain the possibility of their recovery.

6) See that outstanding loans are confirmed by the borrowers.

7) See that interests on loans are regularly collected.

8) See that provisions are made for doubtful loans.

9) In the case of joint stock Company, the auditor should see that the loans are properly classified.

10) See that loans to directors and officials of the company are shown separately in the balance sheet.

11) See that the advances to subsidiary companies are shown separately in the balance sheet.

12) See that loans are shown separately in the balance sheet.

1) Loans against the security of land and building

1) Examine the loans granted with the help of loan agreements.

2) Examine the powers of the person granting the loan.

3) Examine the memorandum and articles of association, in the case of joint stock companies.

4) Inspect the minutes of meeting of the board of directors and see that loans are properly sanctioned.

5) Verify the details of the loan.

6) See that outstanding loans are confirmed by the borrowers.

7) Examine the title deed relating to the property mortgaged.

8) Interests on loans are collected regularly.

2) Loans against the security of stock& shares

1) Examine the loans granted with the help of loan agreements.

2) Examine the list of stocks and shares held by the company.

3) See that shares offered as security is transferred to his client.

4) Check the value and see that there is sufficient margin between the loan and the present value of the security.

5) See that shares accepted as security are fully paid up.

3) Loans against the security of goods

1) Examine the loans granted with the help of loan agreements.

2) Examine the powers of the person granting the loan.

3) Examine the godown keeper's receipt, dock warrant if loans are advanced against the goods lying in warehouse.

4) See that godown rent is paid regularly by the borrower.

5) See that goods offered as security are fully insured.

6) See that goods offered as security are easily saleable.

4) Loans against the security of life policies

1) Examine the loans granted with the help of loan agreements.

2) Examine the powers of the person granting the loan.

3) Enquire into the class of insurance policy.

4) Examine the last receipt for the payment of insurance premium.

5) Ascertain the surrender value of the life insurance policy.

5) Loans against the guaranty of a third party

1) Examine the loans granted with the help of loan agreements.

2) Examine the powers of the person granting the loan.

3) Examine the guaranty.

4) Enquire into the financial position of surety.

6) Loans against the personal security of the borrower

1) Examine the loans granted with the help of loan agreements.

2) Examine the powers of the person granting the loan.

3) Examine the credit worthiness of the borrower. 4) Finally auditor should discourage the client granting of such loans.

13) Verification and valuation of stock in trade

The work of verification and valuation of stock in trade consist of two elements,

1) Verification of stock in trade.

2) Valuation of stock in trade.

i) Verification of stock in trade does not mean merely the checking of stock statements. It is much more than this. It includes the following,

❒ Verification of physical existence of stock in trade.

❒ Verification of ownership of stock in trade.

❒ Verification of guaranties in the statement of stock.

❒ Examine the organization's transactions that results in stock in trade.

❒ Ensuring that receipts and issues are properly recorded.

❒ Ensure that the provision is made for obsolete stock.

❒ Examination of system of internal control.

❒ Verification of arithmetical accuracy of statement of stock.

While verifying stock in trade, an auditor should keep in mind the following points,

1) Examine the system of internal check with regard to the verification of stock in trade.

2) Obtain copies of physical layout of all plant, giving names and descriptions of all departments where stocks are held.

3) Obtain details as to the quantity and value of stock with each department.

4) Secure a copy of stock taking instructions issued to the staff.

5) Ensure that proper and adequate records of stocks have been maintained.

6) See that goods which are not related to the business are not included in the stock.

7) See that goods sold prior to the closing date are not included in the stock.

8) See that items of capital nature are excluded from the stock.

9) He should test check physical existence at least 5 % of items.

10) See that stock held by third party is included in the stock sheet.

11) Compute Work out ratio between gross profit and sales of current year and compare it with that of the previous year.

12) Compare stock sheet of current year with that of previous year.

13) Check calculations, additions and castings in the stock sheet.

14) See that stock sheet is initiated by a responsible person.

15) See that goods taken into stock sheet are passed through the purchase book.

ii) Valuation of stock in trade Following points are to be noted while valuing stock in trade:

1) An auditor should enquire into the basis of valuation.

2) See that basis of valuation has been consistently adopted from year to year.

3) Check the values of few items in the stock sheet with the corresponding invoice prices and current selling prices.

4) See that the totals of stock sheet are correct.

5) Compare the percentage of gross profit of current year with that of previous year.

6) See that calculations, additions and castings are correct.

7) See that stock sheet is signed by a responsible officer.

METHODS OF VALUATION OF STOCK IN TRADE:

❒ Actual cost price method

❒ Simple average cost method

❒ Weighted average cost method

❒ FIFO

❒ LIFO

❒ Base stock method

❒ Standard cost method

❒ Market price method

❒ Net realized value method

Valuation of different items of stock in trade

1) Raw materials are valued at cost price plus proportionate freight and import duty.

2) Work in progress: cost price of raw materials plus proportionate amount of manufacturing expenses plus a percentage to cover the establishment charges relating to manufacture.

3) Finished goods: principal of "cost price or market price whichever is lower" is applied.

4) Spare parts: cost price

5) Stores articles: cost price

6) Stock of special trade: cost price plus interest at remarkable rate plus expenses of maintaining stock.

2.8 VERIFICATION AND VALUATION OF LIABILITIES:

1. See that the liabilities are neither deliberately omitted nor under stated nor overvalued.

2. See that the liabilities are shown in balance sheet at their correct amount.

3. Obtain a certificate from responsible officer as to the correctness of the amount of different liabilities.

1) Verification of sundry creditors

While verifying sundry creditors an auditor should bare in mind the following points:

1) Obtain a list of creditors. He should get a schedule or list of creditors from the management and verify whether the schedule contains all the details about creditors.

2) Check the schedule of creditors with the balance in the creditor's ledger.

3) Obtain statement of account from creditors.

4) Check the purchase book and purchase return book with the help of invoices and credit notes.

5) Check the postings from subsidiary books to the creditors account in the ledger.

6) Examine the purchase invoices to ensure that these are related to current year.

7) Compare the percentage of gross profit of current year with that of the previous year.

8) Special attention to the entries made either at the beginning of the year or at the end of the year.

9) Check the provisions for the discount on creditors with the help of reference to the creditor's ledger. If the credited amount is unpaid for a long period, enquire the reasons.

10) See that creditor's amount shown in the balance sheet are correct.

2) Verification of bills payable

1) Obtain a schedule of bills payable

2) Check the total of schedule of bills payable with the bills payable book and the bills payable account.

3) Verify the payments made to the bills payable with the entries in the cash book.

4) Verify the bills payable returned under rebate.

5) Satisfy himself with the genuineness of bills payable.

6) See that the bills payable which have been paid are not shown as outstanding.

7) Check the bills payable paid after the balance sheet date but before the date of the audit with the entries made in the cash book.

8) See that the bills payable amount shown in the balance sheet are correct.

3). Verification of bank overdraft

1) Examine the overdraft agreement with the bank.

2) Check the cash book with the bank pass book.

3) Obtain a certificate from the bank and verify the correctness.

4) Verify the outstanding interest, if any.

5) If bank overdraft is secured, see that the assets charged against such loans are clearly stated in the balance sheet.

4) Verification of loans &advances borrowed

1) Examine the loan agreement.

2) Examine the loans and advances with the help of the correspondence and relevant documents.

3) Ensure that loans and advances are taken for the use in the business.

4) Check the amount of loans and advances with the confirmation letters received from lenders.

5) If the loans are secured examine the amount of secured loans, nature and value of securities.

6) See that interest on loan is paid or not.

7) See that loans are separately shown in the balance sheet as secured and unsecured.

5). Verification of debentures

1) Examine the memorandum and articles of association to ensure that the borrowing limit is not exceeded.

2) Examine the debenture account to verify the debentures issued.

3) Examine the debenture trust deed to verify amount of debenture issued and securities offered.

4) if debentures are issued at premium or discount, see that premium and discount are properly dealt with in the books of account.

5) If debentures are to be redeemed after some years, he should see that arrangements are made for the same.

6) See that debentures shown in the balance sheet are correct.

6) Outstanding expenses

1) Verify the outstanding expenses with the help of statement of outstanding expenses certified by a responsible officer.

2) Compare the outstanding expenses of current year with those of previous year to see whether there is any material difference.

3) See that outstanding expenses have been subsequently paid.

4) Verify the item of expenses such as salaries, wages, rent etc which remain outstanding.

5) See that outstanding expenses are clearly shown in the balance sheet.

7) Income received in advance

1) Verify the item of incomes which are normally received in advance with the help of list of incomes received in advance certified by a responsible official.

2) See that these are fully disclosed in the balance sheet.

UNIT – III

3 DEPRECIATION

One of the basic objectives of financial accounting it to calculate the true profit or loss from the operations of the enterprise for a particular period. As per matching principle of accountancy the costs of the product must be matched with the revenues in each period.

This principle indicates that if any revenue is earned and recorded then all costs whether paid or outstanding must also be recorded in books of accounts so that the profit and loss account could give a true and fair view of the profits earned or loss suffered during the period and balance sheet presents true and fair view of financial position of the business.

Depreciation is charged on fixed assets. It is an expense item. Fixed assets are those which are of material value, not meant for re-sale and having fairly long life and are used in the business. With the exception of land, all fixed assets have a limited useful life such as plant and machinery, furniture, motor van and buildings.

When a fixed asset is put to use then that part of its value which is lost or which cannot be recovered is known as depreciation. One of .the main characteristics of fixed assets is that because of their physical deterioration while in use their productive capacity can be held constant by putting periodic services to the asset but then the maintenance cost will increase with the life of the asset.

3.1 DEFINITION OF DEPRECIATION

The term depreciation is derived from the Latin words 'do' meaning down and 'pretium' meaning price. In common use it means putting down the value of an asset due to wear and tear, passage of time, obsolescence, etc.

It is very difficult to give a single definition of the term depreciation because under different situation this is handled differently and whatever seems to be correct in one situation may be improper in another. But even then some definitions are worth mentioning.

"Depreciation refers to the process of estimating and recording the periodic charges to expense due to expiration of the usefulness of a capital asset"– Malchman and Slavin.

According to J.N. Carter, "Depreciation is the gradual and permanent decrease in the value of an asset from any cause," J.R. Batiliboi defined depreciation as follows:

"Depreciation represents loss or diminution in the value of an asset consequent upon wear and tear, obsolescence, effluxion of time, or fall in the market value."

The Institute of Chartered Accountants of England and Wales has described depreciation as thus:

"Depreciation represents that part of the cost of fixed asset to its owner which is not recoverable when the asset is finally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned."

The definition given by A.N. Agrawal is as under:

"Depreciation is a permanent, continuing and gradual shrinkage in the value of a fixed asset."

From the above definitions it is clear that depreciation is the gradual, continuing and permanent fall in value of fixed assets. The main causes for this fall in value are wear and tear of assets accidents, passage of time, obsolescence, inadequacies, 'depletion etc.

Even in the recent editions of English language dictionaries the world 'depreciation' has been described as decline in the value of an asset due to such causes as wear and tear, action of elements, obsolescence and inadequacy." Although these traditional views are under pressure because of the recognition of the changes in the value of rupee and replacement costs, even then they have their historical significance.

3.2 CHARACTERISTICS OF DEPRECIATION

The depreciation charged on fixed assets has the following features:

(i) Depreciation is always a fall in the value of asset.

(ii) This fall is always gradual.

(iii) The fall is of permanent character and it cannot be recouped afterwards.

(iv) The depreciation is a continuous process and it does not matter whether the asset was put to use during the period or not.

(v) Depreciation is always on fixed assets and not on current or floating assets.

(vi) Depreciation is the fall in the book value of the asset and not in market or exchange value.

(vii) Depreciation is the result of the use of assets, passage of time and obsolescence.

3.3 CAUSES OF DEPRECIATION:

(i) Use of the Assets or Wear and Tear:

The main cause of depreciation is the wear and tear of assets when they are put to use in the enterprise. It reduces the future technical capacity as well as earning power of the asset with the result that it brings reduction in the value of asset.

(ii) Accident:

Another important contributing factor to depreciation is accident such as plant break down, loss by fire, etc.

(iii) Expiration of Certain Legal Rights:

In case of patents, leases and licenses depreciation is a time function as by the expiration of time for which legal right to use is created lapses.

(iv) Obsolescence:

Because of technological developments, the asset in use may become outdated and lose a large part of its value. This fall may also be the result of changes in tastes and habits of customers, changes in the supply and location of material resources, etc.

(v) Inadequacy:

Sometimes there may be a necessity of putting the assets out of use despite the fact that the asset is in good physical condition. It is because of inadequacy. Inadequacy refers to the termination of the use of an asset because of growth and changes in the size of the firm. For the needs of the firm the asset may not be adequate and another firm of small size may buy it.

(vi) Depletion:

Where the asset is of wasting character, due to the extraction of some materials, such as mines, forests, quarries and oil wells, the asset will be depleted.

3.4 NEED FOR PROVIDING DEPRECIATION:

The providing of depreciation on fixed assets is important because of the following reasons:

1. To Know the True Profit or Loss:

The depreciation is an expense though not payable to any outside party and does not involve outflow of funds. But even then when the fixed assets are put to use in the business, the loss in their value must also be acknowledged to know the true profits or losses. As per matching principle of accounting, all costs must be recorded whether paid or not which are incurred to earn revenue.

2. To Show True and Fair View of Financial Position:

The correct financial position of a business is depicted by balance sheet. While preparing balance sheet, it is necessary that fixed assets are shown at figures derived after deducting depreciation from their book values.

If the assets are shown in balance sheet at their book values without deducting the amount of depreciation then the fixed assets might be overstated and balance sheet may not show true and fair view of financial position.

3. To Provide Funds for Replacement of Assets:

Depreciation is a source of funds for the replacement of assets. After useful life, sufficient funds will be required at the disposal of the firm if proper depreciation provisions are made. If no depreciation has been charged then the firm may face financial difficulties for replacement after the assets become useless.

3.5 BASIC FACTORS IN ESTIMATING DEPRECIATION

To determine the amount of depreciation of a fixed asset, the following factors are to be taken into consideration:

(a) Cost of the asset;

(b) Useful life of the asset, and

(c) Salvage value.

(a) Cost of Asset:

The cost of the asset includes all reasonable expenses that are incurred to bring the asset in a 'workable condition. For example, if old machinery is purchased, the cost will include the purchase price paid, cost of overhauling, polishing and installation.

The main test whether an expense is to be included towards cost price or not, is that whether the expenditure was reasonable and necessary to make the asset in a workable condition.

If the answer is in affirmative, it will become the part of cost, otherwise not. Further, if the firm constructs its own asset, the amount of cost will include all the expenses incurred on its construction. The cost of the asset minus salvage value is the base because this will be the total amount which is to be written of as depreciation throughout the useful life of the asset.

(b) Useful Life of the Asset:

The determination of the useful life of an asset is of great importance because it is the useful life over which the whole cost of the asset is to be written off by way of depreciation.

The useful serviceable life is estimated either from depreciation rates published by income tax authorities or from opinions of engineers or experience with similar assets, guess work, etc. However the intensity of use of the asset, wear and tear, obsolescence and maintenance are the main factors which are taken into consideration for estimating the useful life of the asset.

(c) Salvage Value:

Salvage value is the amount that can be recovered from the sale of the asset after the expiry of its useful serviceable life. In those cases where this amount is insignificant, it is ignored altogether but when this amount is quite substantial, the depreciation is calculated on net cost of the asset, i.e. original cost less salvage value.

3.6 METHODS FOR PROVIDING DEPRECIATION:

(i) Fixed Installment or Straight Line Method
(ii) Fixed Percentage on Diminishing Balance Method

(iii) Sum of the years Digits Method.

(iv) Annuity Method.

(v) Depreciation Fund Method.

(vi) Insurance Policy Method.

(vii) Revaluation Method.

(viii) Machine Hour Rate Method.

(ix) Depletion Method.

(x) Repairs Provision Method.

(i) Fixed Installment or Straight Line or Fixed Percentage on Original Cost. Under this method, the Depreciation is calculated on the basis of either a fixed percentage of the original value of the asset or divides the original value of asset by the number of years of its estimated life. Every year, the same amount is written off as Depreciation so as to reduce the asset account to nil.

Depreciation =
(Cost of the Asset + Installation Charges – Scrap Value + Removal Cost) / Estimated useful Life of the Asset

(ii) Diminishing Balance Method. Under the diminishing Balance method, depreciation is calculated at a fixed percentage on the opening balance of each year. Each year the opening balance may be decreasing in value. This decreasing book value is commonly known as written down value of the asset. While applying the depreciation rate both salvage or scrap value and removal costs are ignored. There are no possibilities to reduce the book value to zero.

(iii) Sum of the Years Digits Method. It gives decreasing depreciation charge year by year. For the purpose of obtaining yearly depreciation diminishing percentages to the cost of the asset, less salvage value is applied. Under this method, the rate of depreciation is a fraction having the sum of the digits representing the useful life of the asset as its denominator and individual year as its numerator.

(iv) Annuity Method. Under the Annuity method, the annual depreciation charges would be ascertained with the help of Annuity table. This method gives importance to interest factor. Other methods do not take into account the interest factor while investing the assets. Fixed interest rate is charged on the opening balance of each year and then cost of asset together with interest thereon is written off equally over the life of the asset.

(v) Depreciation Fund Method. Depreciation fund method provides an adequate financial requirement for the replacement of the asset when the asset is replaced by a new one. Depreciation fund account is opened and the amount of depreciation is credited to that account. The asset account stands year after year at its original cost. At the end of each year, the amount of depreciation is debited and depreciation fund account is credited and the corresponding amount is invested in securities of some reputed companies, for the purpose of mobilizing funds for replacement.

(vi) Insurance Policy Method. Under this method, an insurance policy is taken from the insurance company for the purpose of replacement of an asset. At the end of the definite period, the insurance company will pay the assured sum with the help of which asset can be repurchased.

(vii) Revaluation Method. This method is suitable for small and diverse items of asset such as bottles, corks, trade marks, loose tools, livestock etc. Under this method the amount of depreciation is ascertained to find the difference between the book value of the asset and the real value of the asset. At the end of the year the difference is taken as depreciation.

(viii) Machine Hour Rate Method. The Economic Life of the asset is estimated in terms of working hours. Hourly rate is determined by dividing total cost of the asset by total number of hours to be operated in its life time. The annual depreciation charge is calculated by applying this rate to the actual number of hours operated in the particular accounting period.

Machine hour rate = (Cost – Scrap Value) / Total hours (who l e lifetime)

Depreciation for the year = Machine Hour value x Estimated Hours in a year.

(ix) Depletion Method. The Economic Life of the asset is determined by geographical survey methods in terms of total units of resource deposits. The depletion rate per unit is calculated by dividing the total cost of the asset by the estimated available number of units.

(x) Repairs Provision Method. Under this method, first the total repair and renewal costs are determined for the whole life of the asset and then it is added to the capital cost to get a total value. Then, this value is divided by its estimated life. The resultant value is treated as Repair, Renewals and depreciation. It has to be charged to the profit and loss Account each year. The corresponding Credit is given to provision for depreciation and Repairs account.

3.7 AUDITOR'S DUTY REGARDING DEPRECIATION

The auditor's duty in case of depreciation is summarised below:

1.It is the duty of the auditor to ensure that depreciation is provided adequately and the depreciation charged is properly disclosed in the profit and loss account and the balance sheet. If the auditor is not satisfied on the above, he should report the same.

2. The auditor should see whether relevant principles of accountancy have been followed it making provision for depreciation.

3. He should see whether the officers of the business have sincerely and honestly made provision for depreciation.

4. He should check whether the principles followed from year to year for providing depreciation are more or less the same.

5. The auditor should examine as to whether the capital employed in the assets is being kept intact.

6. He should see whether the business traditions and rules have been fully considered.

7. He should see whether the provisions of companies act as regards depreciation have been duly compiled with.

8. He should see whether all the disclosures as required by AS 6 and the companies act have been duly made in the financial statements.

But if he finds that:

1.The depreciation has not been dealt with honestly by the management.

2. Competent persons have not been employed, and if employed they have not carefully examined the issue.

3. The provision for depreciation is not adequate.

4. The principles of accountancy have not been followed by the management in making the charge for depreciation.

5. The disclosures as required by AS 6 as well as the companies act have not been made.

The auditor should draw the attention of the owners of the business towards the issue and mention the fact in his report. If there is any change in the method of providing for depreciation, it must be disclosed in the profit and loss account along with its effect on the profit or loss for the year.

3.8 RESERVES

Reserve may be referred to an amount, which is set aside out of the profits of a business for any kind of known and unknown contigency, liability and diminishing value of assets. It is an appropriation of profits before declaration of dividend and not a charge on profit. It denotes that part of profits, which is retained in the business. In other words it consists of profits or surplus assets, which are not distributable. Reserve is kept aside for emergency likely to arise in the future.

3.8.1 DEFINITION OF RESERVE

According to the American Institute of Accountants, "The use of the term "Reserve" be limited to indicate that an undivided portion of the asset is being held or retained for general or specific purpose".

It is clear from the above definition and explanations that reserve is an appropriation against profit and loss account with a view to meet general contigencies or specific purposes.

3.8.2 CHARACTERISTICS OF RESERVE

The basic characteristics of reserve are as follows:

1.The reserve is an appropriation of divisible profit

2. It is provided to meet known and unknown future contigencies or unexpected loss.

3. Reserve is not a charge against profit.

4. It serves as additional fund for working capital.

5. The creation of reserve is not compulsory except in the case of banking business and joint stock companies.

3.8.3 CLASSIFICATION OF RESERVES

Reserves are classified into six types. They are

1. General Reserve
2. Capital Reserve
3. Specific Reserve
4. Secret Reserve
5. Reserve Fund
6. Sinking Fund

A brief explanation of these types of reserves is as follows:

1.General Reserve:

When any amount is kept separate by a company out of its profit for future purpose then that is called as general reserves. In other words the general reserves are the retained earnings of a company which are kept aside out of company's profits to meet future (known or unknown) obligations. General reserves are the part of Profit and Loss Appropriation Account.

In other words the general reserve is a free reserves which can be utilized for any purpose after fulfilling certain conditions.

On the basis of above definitions general reserve may be utilized for following purposes:-

- To settle any unknown future contingencies
- To increase the working capital
- To strengthen the financial position of the company
- To pay dividends to shareholders more than specified limits
- General reserves kept to offset some specific future losses.
- General reserves includes the money kept aside for litigation or revaluation.
- General reserves are shown in liabilities side of balance sheet.

Duties of an Auditor in verification of General Reserves

1. The auditor has to verify the minutes of the board of directors and ensure that the profits are appropriated as per the decision taken by the directors.

2. The auditor should ensure that the requirements of Articles of Association regarding the appropriation of profit to general or special reserves are duly followed by the company.

3. The auditor should verify the accounts and ensure that the company has transferred the required amount to the general reserves and special reserves before declaring the dividend, as required by the company law.

4. If any part of the general reserve is utilized for payment of dividend, the auditor should ensure that the provisions of Companies Act are duly complied with.

5. The auditor should also ensure that the reserves are utilized only for the purpose for which they are created.

6. He should also ensure that the general reserves and special reserves are disclosed in the liabilities side of the balance sheet under appropriate heads.

2. Capital Reserve

A reserve which is created out of the capital profit is known as capital reserve. It is not created out of the profit earned in normal course of the business. Capital reserve is created out of the profit earned from some specific transactions of capital nature. Capital reserve is not available for the distribution to the shareholders. The examples of capital profit from which capital reserve is created are as follows:

* Profit on sale of fixed assets
* Profit on sale of investment
* Profit on revaluation of assets and liabilities
* Premium on issue of shares and debentures
* Profit on re-issue of forfeited shares
* Discount on redemption of debentures
* Profit on purchase of an existing business

Objectives And Advantages Of Capital Reserve

The following are the objectives and advantages of capital reserves

* Capital reserve helps in making the organization financially strong.
* Capital reserve helps in writing off the capital losses arising from the sale of fixed assets, shares and debentures.
* Capital reserve helps in the issue of fully paid bonus shares to the existing shareholders.

Auditor's Duty in auditing of Capital reserve

1. The auditor should see that a capital reserve is created out of capital profit only.

2. He should ensure that capital reserve is utilized for meeting losses of capital nature.

3. In case capital reserve is used for distribution among the shareholders by way of dividend, he should examine the rules given in the Articles of Association and Law.

4. The auditor should see whether it is shown separately in the Balance Sheet and distinguished from the revenue or general reserve.

5. He should verify whether it is invested outside securities or retained in the business.

3. SPECIFIC RESERVE:

A specific reserve is one, which is created for some specific purpose by debiting Profit and Loss Appropriation Account. Normally, it is available for the purpose for which it has been created.

Examples of Specific Reserve

Some of the examples of specific reserves are as below:

i. Dividend Equalization Reserve.

ii. Investment Fluctuation Reserve.

iii. Debenture Redemption Reserve.

iv. Plant and Machinery Replacement such as Sinking Fund Reserve or Depreciation Fund Reserve.

However, sometimes, at the discretion of the Board of Directors in a company, a specific reserve may be utilized for a purpose other than one of its creation, e.g., Investment Fluctuation Reserve may be utilized by the Board, after passing the necessary resolution, in paying dividends to shareholders.

Objects of Creating Specific Reserve

Generally, the specific reserve is created with the following objectives:

1. To meet out outstanding liabilities for expenses due.

2. To write off loss arising out of depreciation or diminution in assets such as depreciation reserve.

3. To meet specific contingency such as provision for bad and doubtful debts, provision for discount, and provision for fluctuation in the investment.

Auditor's Duty in specific reserve audit

In case of specific reserve, the auditor should follow the following procedure:

1. Auditor should verify the objective with which provisions have been made.

2. He should see that the provision made is adequate to meet the objective.

3. If the provision made is not adequate he should ask the management to do the needful to increase it; otherwise he should disclose the same in his audit report.

4. He should see whether the provisions are properly shown on the liability side of the Balance Sheet.

5. In case specific reserve holds any other purpose other than the one for which it is created, the auditor should see that the Board has authorized it properly.

4. Secret Reserve:

The term secret reserve refers to a reserve the existence of which is not disclosed in the Balance Sheet. Secret reserves are also called ***Hidden Reserve*** or ***Internal Reserve***. Such a reserve is not disclosed on the Balance Sheet. It can be said that there is a surplus of assets over liabilities and that surplus is not disclosed or shown by the Balance Sheet.

Method of Creation of Secret Reserves

Secret reserves may be created in the following ways:

1. Providing excess depreciation on fixed assets such as plant, machinery, land & building, furniture and fixtures, etc.

2. Writing down an asset completely.

3. Understating goodwill.

4. Undervaluing assets such as stock, investments, etc. and showing them much below their cost or market value.

5. Non-recording of permanent rise or appreciation in value of a fixed asset, e.g., buildings.

6. Providing excessively for bad and doubtful debts..

7. Overvaluing liabilities.

8. Including of fictitious liabilities.

9. Showing contingent liabilities as real liabilities.

10. Suppression of accrued income and prepaid expenses.

11. Making excess provision for expenses.

Objects of Creating Secret Reserve

The inherent ideas of creating secret reserve are as follows:

1. Maintaining a strong financial position.

2. Improving the solvency position of the entity.

3. Meeting sudden future financial losses.

4. Facing competitions.

5. Confusing the rivals regarding profitability.

6. Providing additional working capital.

7. Maintaining a stable dividend payment.

8. Hiding a portion of profit.

9. Enabling the directors to tide over unfavorable time.

10. Helping the management not to distribute the hide portion of profit, which is retained in the business in the form of secret reserve to the shareholders in the interest of the business.

Auditor's Duty in auditing secret reserves

While verifying the secret reserve, the auditor should keep the following points in mind:

1. He should enquire and find out what is the necessity of creating a secret reserve.

2. He should study thoroughly the Articles of Association and examine the legality or otherwise of creating a secret reserve. He should see whether the intentions of directors are quite honest.

3. He should try to collect as much information as possible about the creation of a secret reserve. He should satisfy himself about the method and the procedure of creating such a reserve.

4. Sometimes the managements create secret reserves by means of overvaluing liabilities or undervaluing assets. In such cases, the auditor should discuss the issue with the management and go deep into the policy and practices behind it.

5. Unless it is felt absolutely necessary to create a secret reserve, he should not accept the creation of a secret reserves valid and if he feels so he should ask the management to prepare the revised annual account.

3.9 RESERVE FUND

The word "Fund" in relation to any reserve can be used only where such a reserve is specifically represented by earmarked investments. In other words, the expression "Reserve Fund" is used only when there are earmarked investments for it; otherwise it is called only "General Reserve".

A reserve fund cannot exist, side by side, with the debit balance on Profit and Loss Account. Thus, if there is a debit balance in the Profit and Loss Account it must be shown as a deduction from the Reserve Fund or General Reserve under the heading Reserves and Surplus on the liabilities side of the Balance Sheet.

3.9.1 Utilization of Reserve funds

Under section 80 of the Companies Act, whenever a company redeems its preference shares without issuing fresh shares, it has to transfer from its profits, which are available for distribution, a sum equal to the nominal value of the preference shares so redeemed, to the capital redemption reserve. The company can use the reserve funds only for the purpose of issuing fully paid-up bonus shares to its members.

In the absence of special Articles to the contrary, the directors of a company may transfer the whole or any portion of the Reserve Fund to the credit of Profit and Loss Appropriation Account for the purpose of increasing the amount of profit available for dividends.

3.9.2 Auditor's Duty in Reserve Funds audit

In case of reserve fund, the auditor should adopt the following procedure to verify it:

1. The auditor should see that a reserve fund is shown separately on the liability side of the Balance Sheet.

2. He should see that fund is created for meeting the earmarked purpose.

3. He should see that the amount of reserve fund is invested in easily realizable securities.

4. He should ascertain that the amount invested in outside securities is not less than the amount of reserve fund.

3.10 SINKING FUND

A sinking fund is a fund, which is created with a specific purpose such as

1. To redeem or repay a long term liability such as debenture, long term loans, etc.

2. To replace a wasting asset, such as a mine.

3. To replace an asset of depreciable nature such as plant & machinery, land & buildings, etc.

4. To renew a lease.

In case of sinking fund, every year a fixed sum of money is set aside for a definite period, which is invested at compound interest, so that at the end of the period the annual amounts, with interest accumulation, will be sufficient to repay the outstanding loan. In such cases, the amount set aside should not be debited to Profit and Loss Account, but to Profit and Loss Appropriation Account because in case of repayment of liability, the sum set aside is in the nature of allocation of profits and not in the form of charge against them.

3.10.1 Auditor's Duty in auditing sinking fund:

In case of sinking fund, the auditor should keep the following points in mind:

1. Auditor should see that a sinking fund is created as per the provisions of the Articles of Association.

2. He should be familiar with the terms and conditions regarding the creation of a sinking fund and see that they have been duly complied with.

3. He should check the charge made to profit towards the sinking fund account.

4. He should ensure that the amount of sinking fund is properly invested in easily marketable securities.

5. He should see that the interest on investment is received and accounted in the books of accounts as per the investment deed.

6. He should verify that the investment against sinking fund is clearly shown separately in the Balance Sheet.

7. He should see whether the sinking fund investments are sold on the due date and also that the profit or loss made on realization of investment is transferred to the Sinking Fund Accounts only and not to Profit and Loss Account.

3.11 PROVISIONS

If some loss is anticipated but its exact amount cannot be ascertained, a provision is made. Such provisions may be made either to provide for losses, which may arise on the realisation of certain assets, or on accruing liabilities. The exact amount cannot readily be made known for the present in cases such as provision for bad debts, provison for discount, provision for taxation, etc.

3.11.1 Characteristics Of Provision:

The following are the important characteristics of provision:

1.It is an amount set aside out of profit

2. Its object is to meet any known contigency

3. The exact amount of loss cannot be ascertained.

3.11.2 Purpose Of Creating Provision:

There are a number of factors that could cause a company to create provisions, however, there are certain requirements that must be fulfilled before a financial obligation can be viewed as a provision. These include that:

- The company must perform a reliable amount of regulatory measurement of the obligation. The measurement must be undertaken by company management.
- It must be probable that the obligation results in a financial drag on economic resources.
- An obligation must be a result of events that will advance the balance sheet date and could result in a legal or constructive obligation.
- An obligation must be determined to be probable, but not certain. It must be estimated to have a more than 50% probability of occurring.

3.12 DIFFERENCE BETWEEN PROVISION AND RESERVE ARE STATED IN THE TABULAR FORM:

1. It is a possible loss so it is created by debiting profit and loss account. It is a charge against profit	1. It is a portion of profit earned by business. It is created by debiting profit and loss appropriation account. It is an appropriation of profit.
2. Profit and loss account will not disclose true profit/loss, unless provision is created.	2. Profit and loss account discloses true profit/ loss, even if no reserve is created.
3. It is created to meet specific loss or liability. But the amount of loss or liability cannot be determined exactly. So the amount of provision is an estimated amount.	3. It is meant for meeting any unknown loss or liability. It is generally created with a portion of profit earned by business.
4. It must be created irrespective of whether there is a profit or loss. In other words its creation is obligatory.	4. It cannot be created unless there is a sufficient profit. Its creation is the discretion of management. In other words, it is not obligatory.
5. Profit or loss is effected by its creation - profit decreases or loss increases.	5. It does not effect profit or loss, since it is created after ascertaining profit.
6. Dividend cannot be paid out of it.	6. Dividend can be paid out of it.
7. Its amount must be sufficient to meet the loss or liability.	7. Its amount is generally determined by management on the basis of the amount of profit earned.

8. It cannot increase working capital - it is utilized for meeting the specific loss or liability.	8. It increases working capital and thereby strengthen the financial position of the business concern.
9. The owner of the business cannot have any claim over it, since it is created for meeting a specific loss or liability.	9. The owner can claim it, since it is created out of profit.
10. It is shown on asset side of the balance sheet as deduction from the concerned asset, e.g., provision for doubtful debts is shown as deduction from sundry debtors.	10. It is shown on liability side of the balance sheet as a separate item.
11. It is used for the specific purpose for which is has been created.	11. It can be used for the purpose whatsoever.
12. Auditors must check its adequacy.	12. Auditors are not required to check adequacy.

In spite of the above distinction between provision and reserve it may be noted that both of them are created out of the same source, i.e. revenue of the business. Again, if there be any surplus provision after meeting the liability or loss for which it was created, such surplus provision is as good as reserve. For example, a provision of $500 is created in this year for doubtful debts. But actual bad debts in the next year comes to $400 only leaving a surplus provision of $100 (500 - 400). This surplus will be credited to profit and loss account. In other words, it becomes payable to the owner of business like reserves.

3.13 DUTIES OF THE AUDITOR WHILE VERIFYING PROVISIONS

The profit of a company is arrived at only after making necessary provisions. If the provisions are inadequate, the profit may be overstated and thereby dividend may be paid out of capital. On the other hand, if the provisions are made in excess, the account may not show the true and fair state of affairs of the business. Therefore, it is the duty of the auditor to verify that all the provisions are made during the year with care. The following are some of the important role of auditors while verifying provisions.

1. He should verify that provisions are made with regard to all liabilities and contingencies.

2. He should ensure that the amount provided is adequate.

3. He should examine the Minutes of the meeting of the board of directors and the provisions of Articles of Association regarding the provisions to be made.

4. He should ensure all provisions are made by debiting the profit and loss account.

5. He should ensure that the provisions are utilized only for the purpose for which they are created.

6. He should ensure that all the provisions are properly disclosed in the financial statements.

7. If the auditor is of the opinion that any of the provisions made is in excess or inadequate, he should advise the management to provide correct amount. If the management fails to do so, he may give his opinion on the same in his report.

3.14 DEFINITION OF 'WASTING ASSET'

An item that irreversibly declines in value, as a function of time. Wasting assets include vehicles, machinery and other fixed assets. Accountants attempt to quantify the amount that assets decrease in value over time, by assigning depreciation schedules to wasting assets, therefore, recognizing the decrease in value each year.

UNIT – IV

4 AUDIT OF LIMITED COMPANIES

The companies Act not defined the term 'auditor '. But one can define an auditor as a qualified Chartered Accountant within the meaning of the Chartered Accountants Act of 1949 appointed for the purpose of examining the accounts of a joint stock company and giving the report there on to the shareholders every year at the annual general meeting.

4.1 QUALIFICATION OF AN AUDITOR

A person can be appointed as an auditor of a company only if he is a Chartered Accountant within the meaning of the Chartered Accountants Act of 1949. In case a firm is appointed as an auditor of a company, all the partners of the firm must be Chartered Accountants. One holder of a certificate under the Restricted Auditors Certificate Rules 1956 is also qualified to Act as an auditor of a company.

4.2 DISQUALIFICATION OF AN AUDITOR

Certain persons are disqualified from being appointed as auditor of a company. They are:

(1)A body corporate

(2)An officer or employee of the company

(3) A person who is a partner or who is the employment of an officer or employ of a company.

(4) A Person who is indebted to the company for an amount exceeding RS1000.

(5) A director or a member of a private company.

Besides the above disqualification, certain additional disqualifications are also prescribed by the companies (Amendment) Bill 2003. These are:

(1) An auditor who has any direct financial interest in the company.

(2) An auditor who received only loan or guarantee from or on behalf of the company.

(3) An auditor who has any business relationship in the company.

(4) An auditor who has been employed in the company

(5) An auditor whose relative is in the employment of the company

4.3 APPOINTMENT OF AN AUDITOR

4.3.1 First Auditor:

The first auditor of a company is appointed by the Board of Directors within the month of the Registration of the company. The first auditor, appointed by the Board of Directors will hold office till the conclusion of the first annual general meeting of the company. If Board of Directors fails to appoint the first auditor, the company may appoint the first auditor in the general meeting. The first auditor appointed by the shareholders in the general meeting, will also be reappointed at the first annual general meeting of the company

4.3.2 Subsequent Auditor:

Every subsequent auditor is appointed every year at every annual general meeting by the shareholders. A subsequent auditor appointed by the shareholders at any annual general meeting will hold office till the conclusion of the next annual general meeting.

4.3.3 Appointment Of An Auditor By The Central Government

If a subsequent auditor is not appointed by the shareholders at any annual general meeting, the company must bring it to the notice of the central govt. within seven days of the con conclusion of the annual general meeting. On receiving the notice, the central govt. may appoint an auditor to fill the vacancy.

4.3.4 Appointment In Case Of Casual Vacancy

Any casual vacancy in the office of an auditor can be filled up by the board of directors. However, the casual vacancy caused by the resignation of an auditor cannot be filled up by the Board of Directors; it can be filled up by the shareholders at the general meeting. An auditor appointed to a casual vacancy can hold office only till the conclusion of the next annual general meeting.

4.3.5 Appointment Of Auditor By Special Resolution

In the case of companies mentioned below, appointment and reappointment of auditors at the annual general meeting shall be made only after passing a special resolution.

1. A company in which not less than 25% of the subscribed share capital is held as on the date of annual general meeting, jointly or singly, by,

   a. a nationalized bank or a general insurance company or

   b. any institution, financial or otherwise, established under State or Provincial Act, in which, not less than 51% of the subscribed capital is held by the State Government or

   c. a central Government or a state government or a government company or a public financial institution.

Here, the following are to be noted:

1. Subscribed share capital includes preference share capital.

2. Special Resolution for the appointment of auditor is necessary even if a nationalized bank holds shares of the company in its name as security for loans advanced by it.

3. If any of the above mentioned companies fails to appoint the auditor by passing a special resolution in its annual general body meeting, the Central Government has the power to appoint the auditor of the company.

The term Public financial institution means

a. any institution constituted under any Central Act or

b. any institution in which not less than 51% of the paid up share capital is held or controlled by the Central government

c. The official gazette of the Central government mentioning the names of the Public Financial Institutions.

4.3.6 Reappointment Of Auditor

1. A retiring auditor may be re-appointed at the annual general body meeting by passing a resolution.

2. Reappointment of a retiring auditor is not automatic. A resolution at the annual general body meeting is required.

However, a retiring auditor shall not be reappointed,

a. When he does not qualify for reappointment.

b. When he is not interested or expressed unwillingness to accept reappointment.

c. When a resolution is passed in the AGM appointing some other auditor. Companies (Amendment) Bill, 2003 requires a special resolution.

d. When opted not to reappoint him.

e. When resolved to appoint some other auditor and such resolution could not be proceeded with, due to death, or disqualification of such person.

4.4 CEILING ON THE NUMBER OF AUDITORSHIP

1. Any person who is full-time employment elsewhere cannot be appointed as an auditor.

2. Further no company or its Board of directors shall appoint a firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of the specified number of companies or more than the specified number of companies.

3. In the case of a firm of auditors, "specified number of companies" shall be construed as the number of companies specified for every partner of the firm who is not in full-time employment elsewhere.

4. Where any partner of the firm is also a partner of any other firm or firms of auditors, the number of companies which may be taken into account, by all the firms together, in relation to such partner shall not exceed the specified number in the aggregate.

5. Further where any partner of a firm of auditors is also holding office, in his individual capacity, as the auditor of one or more companies, the number of companies which may be taken into account in his case shall not exceed the specified number, in the aggregate.

6. The ceiling on number of company audits does not include a private company.

7. A person or firm holding, appointment as the auditor of a number of companies exceeding the specified number, shall, within sixty days from such commencement, intimate his or its unwillingness to be re-appointed as the auditor from the financial year next following such commencement, to the company or companies of which he or it is not willing to be reappointed as the auditor; and shall simultaneously intimate to the Registrar the names of the companies of which he or it is willing to be re-appointed as the auditor and forward a copy of the intimation to each of the companies referred to therein. "specified number" means,

(a) in the case of a person or firm holding appointment as auditor of a number of companies each of which has a paid-up share capital of less than rupees twenty-five lakhs, twenty such companies

(b) in any other case, twenty companies, out of which not more than ten shall be companies each of which has a paid-up share capital of rupees twenty-five lakhs or more.

In computing the specified number, the number of companies in respect of which or any part of which any person or firm has been appointed as an auditor, whether singly or in combination with any other person or firm, shall be taken into account.

4.5 REMOVAL OF AN AUDITOR

An auditor may be removed before the expiry of the term for which he has been appointed. The first auditor appointed by the directors of the company may be removed before the expiry of his term of office and another person may be appointed in his place by the shareholders at a general meeting by passing an ordinary resolution to that effect. A subsequent auditor appointed by the shareholders at an annual general meeting can be removed from the office before the expiry of his term of appointment by the shareholders in general meeting by passing an ordinary resolution after obtaining previous sanction of the central govt.

For the removal of any auditor before the expiry of his term of office and for the appointment of another auditor in his place, in the following procedure has to be followed: First, a special notice of the days containing the proposed resolution to remove an auditor before the term of office and to appoint a new auditor in place must be given to the company by any member interested. On receipt of the notice of such resolution, the company must send a copy of the resolution to the auditor who is sought to be removed. After receiving a copy of the proposed resolution, the auditor concerned can make his representation to the company. There after, if the members desire that the auditor should be removed before his term of office and another person should be appointed in his place, an ordinary resolution should be passed by the share holders at the general meeting. It may be noted that for the removal of a subsequent auditor, the provisions approval of the central government also must be obtained.

4.6 REMUNERATION OF AN AUDITOR

The remuneration of the first auditor is fixed by the Board of Directors, if he is appointed by the Board of Directors. The remuneration of every subsequent auditor, who is appointed by the company, is fixed by the company in the general meeting. Where a subsequent auditor is appointed by the Central government on the failure of the company to appoint the auditor, his remuneration will be fixed by the Central Government.

4.7 AUDITORS LEIN

The auditor can exercise his lien on client's books and records subject to the following conditions:

(a) Document retained must belong to the client who owes the money.

(b) Such documents must have come into auditor's possession with the client's authority.

(c) Some work must have been done and fees for work performed must be outstanding.

But a company needs to keep it's books at the registered office.23 January 2015

4.7.1 Legal Status Or Position Of A Company Auditor

1) An agent of the shareholders.

2) An officer of the company.

3) A servant of the company

4.8 RIGHTS OF A COMPANY AUDITOR

1) Right of access to books of account of Vouchers: An auditor of a company has a right of access to the books of accounts and vouchers of the company whether they are kept at the head office of the company or elsewhere.

2) Right to examine the cost records: An auditor of a company has a right to examine the cost records along with the quantitative records relating to production, sales, stocks etc.

3) Right to obtain information and explanations: An auditor of a company has a right to obtain from the directors and officers of the company such information and explanation as he may think necessary for the performance of his duties as an auditor.

4) Right to correct any wrong statement: An auditor of a company has a right to correct any wrong statement made by the Directors relating to the accounts to be laid before the company in the general meeting.

5) Right to comment on the inadequacy of the accounting system in his report: If the system of maintaining accounts is inadequate, he can advice the directors to amend the system of accounting.

6) Right to visit branches: The auditor of the company can visit the branch and examine the books and accounts and vouchers at the branch.

7) Right to receive notice and other communications of general meeting: An auditor of a company has a right to receive notice and other communications relating to any general meeting, in the same way as a member of the company.

8) Right to attend the general meeting of the shareholders: An auditor has the right to attend every general meeting of the shareholders.

9) Right to speak at the general meeting: - An auditor of a company has a right to speak at a general meeting where his certified accounts are discussed.

10) Right to sign the audit report: - An auditor has the right to sign the audit report.

11) Right to report to the members of the company: - An auditor has a right to report to the members of the company, if the accounts audited by him show an unsatisfactory state of affairs.

12) Right to report to the members of the company: - An auditor has a right to report to the members of the company, if the accounts audited by him show an unsatisfactory state of affairs.

13) Right to be indemnified: - An auditor of a company, being an officer of the company, has a right to be indemnified out of the assets of the company, for any liability incurred by him in defending himself against any proceedings by the company.

14) Right to receive any remuneration for his audit work: - An auditor of a company has a right to receive remuneration for his audit work provided he has completed the work which he undertook.

15) Auditor's right of lien: - An auditor has particular lien on the books of accounts audited by him for nonpayment of audit fees.

4.9 DUTIES AND RESPONSIBILITIES OF A COMPANY AUDITOR

The various duties of an auditor of a company can be grouped into four categories. They are:

(1) Statutory duties.

(2) Contractual duties

(3) Certain duties imposed by legal or court decisions

(4) Duties arising out of professional etiquette.

4.9.1 Statutory Duties: -

Statutory duties refer to the duties imposed by the statute, i.e., by the Companies Act. The various statutory duties of an auditor under the Companies Act are:

(1) Duty to make certain enquiries: - An auditor of a Company should enquire:

1. Whether loans and advances have been properly secured.

2. Whether loans and advançes have been shown as deposits.

3. Whether the transactions of the company are not prejudicial to the interests of the company.

4. Whether the personal expenses have been charged to revenue account.

(2) Duty to Report: - An auditor of a company should make a report to the shareholders on the accounts examined by him and balance sheet and profit and loss account.

(3) Duty to comply with the directives of the Central Government: - The Central has been empowered to issue necessary directives to the auditors of certain companies to give specific reports on certain matters. When the central government issues any such directions, the auditors are required to comply with those directives.

(4). Duty to sign his audit report

(5). Duty to give a statement in prospectus: - A prospectus issued by an existing company should contain a statement from the auditor.

(6) Duty to certify the statutory report.

(7). Duty to certify the declaration of the solvency of the company.

(8). Duty to assist Central Government in connection with prosecution.

(9). Duty to make report on public deposits.

4.9.2 The Important Contractual Duties Of An Auditor Are:

1. An auditor has a duty to see that his appointment is in order.

2. He must perform all the duties under common law.

4.9.3 Duties Imposed By Legal Or Court Decisions:

1. An auditor must make himself fully acquainted with his duties under the Companies Act and the Articles of Association of the company.

2. He must not confine himself only to verify the arithmetical accuracy of the balance sheet but should also enquire into its real accuracy and fairness.

3. He should satisfy himself about the valuation of assets.

4. He should perform his duties with great care and skill.

5. It is the duty of a company auditor to check the stock properly.

4.9.4 Duties Arising Out Of Professional Etiquette:

1. Every auditor should carry on his duties with due regard to public interest.

2. An auditor should comply with the rules and regulations formulated by the Institute of Chartered Accountant of India.

3. He must be honest, sincere, technically competent and independent.

4. He should disclose full and fair information about the working and financial position of the company.

4.10 LIABILITIES OF A COMPANY AUDITOR

A Company Auditor is appointed under the Companies Act. So his liabilities are determined by the Companies Act. Under the Companies Act, the liabilities of a company auditor can be grouped under two heads. They are

1. Civil Liabilities

2. Criminal liabilities

4.10.1 Civil liabilities: -

Liability of an auditor to pay damages is known as civil liability. The civil liabilities of company auditor may be grouped under two heads. They are:

1. Liability for negligence

2. Liability for misfeasance

Liability for negligence: -

An auditor of a company is appointed by the shareholders. As such, he becomes an agent of the shareholders; he must safeguard the interest of the shareholders and the company. To safeguard the interests of the shareholders and the company he must exercise reasonable care and skill in the performance of his duties .If he fails to do so, and shareholders or company suffers any loss, the auditor will be held liable to make good the loss.

The civil liability of an auditor for negligence has been confirmed in several leading cases.

For instance London Oil Storage Co. vs. Sears Hasluck and Co: - in this case, the auditor failed to verify the existence of assets as shown in the balance sheet; he is liable to pay damages to the company.

Liability for misfeasance: -

Misfeasance means wrongful performance of a fiduciary duty. In other words, it means breach of duty imposed by law. If an auditor of a company does something wrongfully in the performance of his duties, resulting in financial loss, he is guilty of misfeasance.

If an auditor of a company does not comply with the provisions of section 227 (2) of the Companies Act, which deals with the statements the auditor has to make in his report to the shareholders, he is guilty of misfeasance and is liable to pay fine .

If an auditor signs the auditor's report in violation of the requirements of section 227 and 229 of the companies Act of 1956, he is guilty of misfeasance and becomes liable to pay fine.

An auditor who misapplies any money belong to the company he becomes guilty of misfeasance and liable for damages caused to the company. If an auditor knowingly authorizes the issue of a prospectus which contains a false statement, he becomes liable to pay a fine and imprisonment. The civil liability of an Auditor of a company for misfeasance has been confirmed in many cases.

For instance: In Re London and General Bank Ltd – in this case the assets of the company were overvalued. As a result, dividend was paid out of capital. The auditor was aware of the over valuation of the assets. But he did not report the matter to the share holders. It was held that an auditor is liable for misfeasance. An auditor may be granted relief by the court from the liability for misfeasance if he proved that he has acted honestly and reasonably.

4.10.2 Criminal Liability Of A Company Auditor:

Criminal liability means liability for a crime. It arises out of an act constituting a crime. The criminal liabilities of an auditor may arise under the Companies Act, the India penal Code, the Indian Income Tax Act and Chartered Accountant Act.

Criminal liabilities of an Auditor under the Companies Act

Under the Companies Act an auditor is held criminally liable in the following cases.

1. Under section 63 for misstatement in prospectus.

2. Under section 68 for fraudulently inducing persons to invest money.

3. Under section 233, for on complaints with section 227 and 229 of the company's Act.

4. Under section 240 for failure to assist investigation

5. Under section 242 for failure to assist prosecution of guilty officers.

6. Under section 477, for failure to return property, books or papers.

7. Under section 539 for falsification of books

8. Penalty for deliberate act of commission or omission under section 628.

Criminal liability of an Auditor under Indian Penal Code.

If an auditor issues signs any certificate believing that such a certificate is false in any material point, he becomes punishable. Criminal liability of an Auditor under the income tax act of 1961. An auditor may become criminally liable in the following circumstances.

1. If has been committed of an offence in connection with taxation proceedings, he will be disqualified from representing an assessee for a certain period .

2. If an auditor submits knowingly any false statement in the form of account for the preparation income tax returns, he becomes liable for imprisonment

Criminal liability of an Auditor under a Chartered Accountants Act

1. If a person not being a chartered accountant acts as an auditor of a company and signs any document, he becomes liable for criminal prosecution.

2. A member of the Institute will be deemed to be guilty of professional misconduct if he submits any return, statements or form to the council knowing them to be false.

4.11 AUDIT REPORT

An audit report is a statement through which an auditor submits his findings and expresses his opinion on the state of affairs of the company's business. In other words, it is a statement through which an auditor summarizes result of his audit work. In short it is the medium through which an auditor expresses his opinion on the financial statement of a business.

4.11.1 Characteristics Of Audit Report:

1) It is the medium through which an auditor expresses his opinion on the financial statement.

2) It is the end product of audit.

3) It is based on factual information.

4) The audit report may be short or long.

5) The audit report may be in the form of letter or statement.

6) The audit report is attached to the balance sheet.

4.11.2 Distinction Between An Audit Report And An Auditor's Certificate:

An auditor's report is merely an expression of the auditor's opinion on the financial statement of a business. On the other hand, an auditor's certificate is the declaration as to the truthfulness of a statement given by a person. An auditor's report is based on facts, estimates and assumptions, whereas auditor's certificate is based only on facts. An auditor's report is not guaranteed of the absolute correctness and accuracy of the financial statements. But an auditor's certificate is a guarantee of the absolute correctness and accuracy of the financial statements. If a signed report by an auditor is wrong, the auditor cannot be held responsible. On the other hand, if a duly signed certificate by an auditor is wrong, the auditor will be responsible.

4.11.3 Importance Of An Audit Report:

It is a statutory requirement in the case of a company audit. It is the end product of audit. It summarizes the result of the audit work done by the audit. It is the medium through which an auditor submits his findings and expresses his opinion on the state of affairs. An audit report ensures to the shareholder that the accounts of the company are properly maintained. It is evidence in the court of law

4.11.4 Contents Of Audit Report:

An audit report has to contain matters as per section 227(3) of the companies act of 1956 the audit report of a company cannot contain the following matters:

1) Whether he has obtained all the information and explanation.

2) Whether proper books of accounts as required by law have been kept by the company.

3) Whether the company's balance sheet and profit and loss account are in agreement with the books, accounts and returns.

4) Whether any other statements have been concluded as required by the central govt.

5) Whether in his opinion a)Balance sheet represents true and fair view of the state of affairs. b)Profit and loss account represents correct profit or loss for the financial year.

4.11.5 Essentials Of An Audit Report:

1) It must be a statement of facts.

2) The report must contain the auditor's opinion.

3) The report should not give vague statement.

4) The report should be convincing.

5) The report must be coherent.

6) It must be simple to understand.

7) It must be forceful.

8) It should be unbiased.

9) The information given in the report should be clear and concise.

10) The report must convey to the client the material facts known to the auditor.

11) The report must be signed by the auditor.

12) The report must be attached to the balance sheet.

4.11.6 Types Of Audit Report:

1). Clean or unqualified report

When an auditor is satisfied with the affairs of the company and the fairness of the balance sheet and profit and loss account of the concern, he gives in his report the various matters without any reservations, qualifications or modifications. Such a report is called a clean report or unqualified report. A clean report is given by an auditor when he is satisfied as to the truthfulness and fairness of the accounts and the financial statements of the company

2. Qualified Or Adverse Report

When an Auditor finds some irregularities in the books of accounts or in the financial statements, the auditor gives a report mentioning the irregularities. Such a report is called a qualified report. A qualified report is a report in which the auditor inserts any qualifications, modifications or reservations.

3. Disclaimer Report

The auditor disclaims to give his opinion when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and is, accordingly,unable to express an opinion on the financial statements.

4. Negative Report

The auditor should give negative or adverse report when the effect of a disagreement with management is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

A qualified report is given by an auditor under the following circumstances:

1) When he is not satisfied with the accounts or financial statements.

2) When proper books of accounts as required by law have not been maintained.

3) When there is a violation of the companies act

4) Where report is a material misstatement in the financial statement.

5) Where there is an omission of a material disclosure.

6) When the explanations sought by the auditor are not made available to him.

7) Where the assets are over or under valued.

8) Where secret reserve have been created.

9) Where there is insufficient provision for depreciation.

10) Where there is inadequate provision for bad and doubtful debts.

4.11.7 Contents Of Audit Report:

Audit report format

The key deliverable from your web accessibility audit will be a report. The report should record the findings of the audit and recommend actions to improve accessibility.

There is no set format for such reports but a report should contain enough detail for your technical staff to act to improve accessibility where required.

At the same time, other sections of the report should be written for non-technical staff if they are the intended audience. (For example, required changes to content should be written for the content team.)

The report should not be any longer than it has to be to accommodate the key information:

- Summary;
- Background and methodology;
- Findings;
- Prioritised action list, with suggested fixes and timeline;
- Appendix of audit detail.

Any report longer than 15 pages should contain a table of contents.

Summary

The report summary (sometimes called an executive summary) should contain the key points of the report in very condensed form. It should contain about 400 words, summarising all sections of the report but with most emphasis on the report's findings and what should happen in response.

The summary should be written in plain, non-technical language as far as possible. Its intended audience is anyone involved in or interested in the website.

Background and methodology

The background and methodology section should contain the what, where, who detail of the audit, including:

- The goals of the site;
- The reason for the audit;
- A summary of the audit requirements;
- Who carried out the audit and when;
- What methodology the audit used;
- What the page sample was;
- The WCAG level for which the site was audited.

Findings

Each report should contain a section containing the findings of the audit. You will probably want to know straight away if your website achieves conformance rating Single-A, Double-A or Triple-A with the WCAG. It should also give a high-level description of some of the main issues. For example, it may report that the site contains a substantial number of images that did not have alternative text. It should not, however, list every image without alternative text. This information should be presented in a detailed appendix.

This section should be longer than the summary but not a page-by-page description of every accessibility check.

Prioritised action list

To help you to remedy accessibility problems uncovered in the audit, a key component of the report is an action list. This should contain enough detail to rectify the problems identified.

In some cases, this may be an exact fix. For example, where absolute font sizes are used on the site it should suggest a fix such as: "Replace absolute font size of 12pt for the body style in file mysite.CSS with a relative size of 80%." In other cases, the action may be more generic, e.g. "Ensure that all staff handling images are aware of the need for appropriate alt text and have the skills to create it."

In either event, the action should be clear and unambiguous. Carrying out the action, as described, should be enough to deal with the accessibility problem identified.

The accessibility auditors should also prioritise the actions recommended. This should be done primarily on the basis of gravity: a Level A breach is more significant than a Level Double-A breach, even if the target is to have none of either.

The prioritisation can also take account of how easy or otherwise it is to rectify a breach. "Quick wins" that improve accessibility in the short term should not be deferred just because there are more grave breaches that will take longer to rectify.

The action list should also contain a timeline or roadmap giving an outline of the timescale involved. Timescale is, of course, highly dependent on the budget and other resources available. However, it is still worthwhile to have accessibility specialists set out their view on a realistic timescale to deliver fixes.

Audit detail - appendix

There will probably be further detail arising from the audit. This might include the results from automated tools. The findings of these tools and the actions arising from those findings should be covered in the body of the report.

The results from the tools do not belong in the body of an action-oriented report but it can be included in an appendix. An example of an audit template taken from the WAI website is included for reference in the appendix of this document. Likewise, the completed audit template for each page should be included in an appendix. In this way, supporting detail is available for future reference without cluttering the main report text.

The organisation of detailed appendices may vary. The essential requirement is a full listing of:

- Audit checkpoints;
- Pages checked;
- Conformance of the pages checked with the audit check

UNIT – V

5 AUDITING IN ELECTRONIC DATA PROCESSING ENVIRONMENT (EDP)

Computerized information system environment or electronic data processing environment means an environment where computers are extensively used in an enterprise for the processing of significant financial information. In other words, data processing done with the help of electronic computers is popularly known as electronic data processing or computerized information system (CIS) environment.

5.1 USES OR BENEFIT OF COMPUTERIZED AUDIT

1) Speed : the work of recording of transactions , preparation of books , accounts can be done with greater speed.

2) Greater accuracy : the chances of arithmetical errors and human errors are reduced to minimum.

3) Greater economy: under the mechanized accounting system, work can be done with minimum staff, with minimum cost.

4) Better records: records prepared by machines are neat and clean. It is more legible, systematic and uniform.

5) Greater information : various types of information and statistical data regarding the operation of the business can be easily collected.

6) Interim accounts : interim accounts can be prepared without delay. This will help the management to declare interim dividend.

7) Analysis of data : once the basic information is feed into the computers, it can be sorted in many different ways to provide analysis of statement .

8) Avoid overtime : the work of accounts are done quickly , the accounts can be prepared without any loss of time.

9) Reduction in audit fee: the work load of audit works is reduced by the computers. Hence the computerized audit reduces audit cost.

10) Computerized audit reduces the **monotony of audit** work

11) Computersised audit enhances the **reliability of audit**

12) Computersied audit ensures **flexibility in the audit programme.**

13) Computersied audit is helpful for the **smooth functioning of auditing.**

5.2 PROBLEMS OR DISADVANTAGES

1) It is not suitable for small business forms.

2) Difficulties to detect the errors and frauds.

3) Absence of supporting vouchers.

4) Storage problem

5) Computer frauds and computer virus.

6) Easy to make alterations

7) It creates unemployment.

8) Absence of input documents.

9) Lack of visible output

10) Coding problem.

5.3 AUDIT APPROACHES IN AN EDP ENVIRONMENT

There are three approaches to auditing in an EDP environment . They are

1) Auditing around the computer

2) Auditing with the computer

3) Auditing through the computer

5.3.1 Auditing Around The Computer:

Auditing around the computer is an audit approach under which an auditor carries out the audit in the same way as in a traditional or manual system except that, instead of examining hand written books, he examines computer printouts. Auditing with computers: - under this approach, the auditor does the audit work with the help of computers that is general software. Under this approach, audit work is carried on in an traditional manner, but the computer software is used for certain operations. Auditing through the computer Auditing through the computer means making use of computer in auditing. Under this approach the auditor evaluates the internal control relating to EDP and on the basis of evaluation, he determines the nature , timing , and extent of his sustentative procedures.

5.3.2 Auditing with the computer:

The utilization of computer by the auditor for some audit work and he uses some general software for the purpose of calculating depreciation, printing letters, and duplicate checking and files comparison. The computer is not used for all the audit work it is done manually.

5.3.3 Auditing through the computer:

Auditing through the computer is a process of reviewing and evaluating the internal control in an electronic data processing. The auditor makes use of computer in auditing. In this approach, reliability and accuracy of the results are analyzed through the computer.

5.4 INTERNAL CONTROL UNDER AN EDP ENVIRONMENT

For the control of various problems connected with the installation and operation of computers in accounting and auditing, there should exist an adequate and satisfactory internal control system in the undertaking . The internal control system should be reliable , effective, and should provide timely , authorized and required data from the system. The various internal controls required to be enforced under an EDP environment may be broadly classified into two categories. They are,

1) General EDP controls

2) EDP application controls.

5.4.1 General Edp Controls:

The purpose of general EDP control is to establish a frame work of overall control over EDP activities. Some of the important general EDP controls are,

1) Division of responsibility or duties.

2) Control over development and maintenance of software

3) Control over operators.

4) Control over data access and program access.

5) Control over editing of data.

6) Storage control.

7) Hardware control.

5.4.2 Edp Application Control:

For the smooth working of EDP system, besides the general EDP controls, there should certain special EDP application controls. The important EDP application controls are

1) Control over input

2) Control over processing

3) Output control

5.5 COMPUTER ASSISTED AUDITING TECHNIQUES (CAAT)

Techniques which used computer itself for audit purposes are called computer assisted techniques. The important CAAT are

1) Test data

2) Integrated test facility

3) Controlled processing

4) Computer audit program

Recent trend in auditing or current issues: There are several current issues in auditing. Some of the important current issues or recent trends in auditing are:

1. Audit committees

2. Social audit

3. Inflation audit

4. Human resource accounting and auditing

5. Energy audit

6. Reporting on financial sickness

7. Financial forecast and their audit.

Audit Committees: - An audit Committee is a subcommittee of the board of Directors formed for the purpose of reviewing the annual financial statements before their submission to the Board of Directors, assisting the Board of Directors in discharging their function efficiently and for acting as a liaison between the board of directors and the external auditor.

The setting up of audit Committee has been supported by Stock Exchange, Corporate law authorities, Professional accounting bodies.

The Composition of audit Committee depends mainly up on the nature and the size of the business. An audit committee, generally, consists three to five members.

Functions of Audit Committee are:

1. To consider questions of appointment, resignation, dismissal, remuneration of the auditor.

2. To discuss the nature and scope of duties of external auditor.

3. To review the half yearly and annual financial statements.

4. To discuss the issues and problems arising from the audits.

5. To assist the Board of Directors in the fulfillment of their duties and responsibilities.

6. To evaluate the efficiency of the working of the Board of Directors

Social Audit: -

Social audit is a systematic study and evaluation of a business enterprise's social performance as distinguished from its economic performance. Social audit is intended to evaluate the social performance or social contribution of a business organization

Reporting on Financial Sickness : -

The Sick Industrial Companies are those company which satisfies following conditions:

1. It is an Industrial company.

2. It has been registered for a period of not less than five years.

3. Its accumulated losses at the end of the financial year equal or exceeds its net worth. An auditor is required to assess the financial health of an enterprise, identify initial financial sickness and reporting on the same.

Financial forecasts and their Audit : -

A forecast is a statement of events likely to occur. A financial forecast is a forecast of the financial position of an enterprise in the future. Now a day, certified accountants are required to report on their client's profit forecast and financial forecast.

Inflation audit : -

The accounting which records the effect of changing price is known as inflation accounting. The auditor is required to consider the price level changes recorded in the books of account.

Human resource accounting and auditing: -

It is the accounting and recording of human beings in the organization like other assets. The auditor will be called up on to evaluate the human resource investment.

MODEL QUESTION PAPER

PRACTICAL AUDITING

TIME : 2HOURS AND 30 MINUTES **MARKS: 70 MARKS**

PART – A (2*12=24 MARKS)

Answer Any **Two** Questions In About 500 Words Each:

1.Define auditing. Discuss the objectives of auditing.

2.What is internal control? What are the essential characteristics of good internal control?

3.State the rights and duties of a company auditor.

PART – B (2*7=14 MARKS)

Answer Any **Two** Questions In About 300 Words Each:

4. Discuss the salient features and advantages of Computer Assisted Audit Techniques (CAAT).

5. State the procedure for vouching payment side of cash book.

6. What is secret reserve? What are the objects of creating secret reserves?

PART – C (5*4=20 MARKS)

Answer Any **Five** Questions:

7. a. Distinguish between auditing and accountancy.

   b. Describe vouching procedure of the cash purchases.

   c. Explain the rules concerning removal of a company auditor under the companies act.

   d. What are the advantages of Audit Programme?

   e. What are the causes of depreciation?

   f. What are the disqualifications of the Company Auditor?

   g. How the appointment made of the First Auditors?

PART - D **(2*6=12 MARKS)**

Answer Any **Six** Questions:

8. a. What are the main object of an Audit?

b. What is meant by Internal Audit?

c. What do you mean by Balance Sheet Audit?

d. What is meant by Audit Note Book?

e. What do you mean by Routine Checking?

f. What do you mean by Verification?

g. What is meant by valuation of assets?

h. What do you mean by Wasting Assets?

SCHEME OF VALUATION

PART – A

1. DEFINITION OF AUDITING

Spicer and Pegler have defined audit as " such an examination of the books , accounts and vouchers of a business as will enable the auditor to satisfy himself that the Balance Sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and whether the profit and loss account gives a true and fair view of the profit or loss for the financial period , according to the best of his information and explanation given to him and is shown by the books and if not in what respect he is not satisfied."

OBJECTIVES OF AUDITING

The objective of an audit may be classified as

(1) Primary Objective

(2) Subsidiary Objective

(3) Specific Objective

Primary Objective or Main Objective:

Expression of expert opinion: - The main objective of auditing is to verify the accounts and records and to report to the owners of the business whether the profit and loss account and the Balance sheet have been properly drawn up according to the requirements of law, and whether they exhibit a true and fair view of the profit and the financial position of the business.

To ensure that the primary objective of audit is achieved, an auditor must:

(a) Examine the Internal Control and Internal Check.

(b) Verify whether all the books of accounts as required by law are kept.

(c) Verify whether proper accounting principles and procedures are followed.

(d) Check the arithmetical accuracy of the books of accounts.

(e) Verify the authenticity and validity of the transactions.

(f) Confirm the existence and the values of the assets and liabilities by physical verification.

(g) Find out whether the financial statement is properly drawn up.

(h) Report whether the profit and loss gives a true and fair view of the profit or loss for the year and Balance sheet gives a true and fair view of the financial position of the business at the end of the financial year.

Subsidiary or Ancillary objectives: - Subsidiary objectives of auditing are

(1) Detection and prevention of errors.

(2) Detection and prevention of frauds.

Detection and prevention of Errors: -

Errors refer to unintentional mis statements in the records or books. Errors are two types namely (1) Clerical or technical errors and (2) Errors of principle.

Clerical Errors: - Clerical errors refer to all types of errors committed on account of clerical mistakes. They are (a) Errors of omission (2) Errors of Commission (3) Compensating errors and (4) Errors of duplication.

Errors of Omission: - An error of omission is one which arises when a transaction has been omitted to be recorded in the books of accounts either wholly or partially. An error of omission may be an error of complete omission or an error of partial omission. An error of complete omission does not affect the agreement of the trial balance, as both the aspects of the transaction are omitted from the trial balance, they cannot be detected easily. They can be detected only by an intensive checking of the subsidiary books, and the postings from the subsidiary books to the ledger. On the other hand, an error of partial omission affects the agreements of the trial balance, as only one of the aspects of the transactions is omitted from the trial balance, it can be detected easily.

Errors of Commission: - Errors of commission refer to errors committed in the process of posting from the subsidiary books to the ledger accounts, casting, carry forward and balancing of ledger accounts. Some of the errors of commission will not affect the agreement of the trial balance. They cannot be detected easily. Only a thorough checking of the subsidiary books and posting to the ledger can help to detect these errors.

Compensating errors: - When the effect of one error is counter balanced, set off or compensated by another error, the errors are known as compensating errors or offsetting errors. Compensating errors do not affect the agreement of the trial balance, as they are counter balanced or set off.

Errors of Duplication: - Errors of duplication arise when an entry in a book of original entry has been made twice and also been posted twice.

Errors of Principle: - An error of principle arises when the generally accepted principles of accountancy are not observed, while recording a transaction in the books of account. In other words, if a transaction is recorded in the books of account against the generally accepted principles of accountancy, the error is known as an error of principle. Capital expenditure recorded as revenue expenditure or vice versa, capital receipt recorded as revenue receipt or vice versa is examples of errors of principle. Errors of principle will not affect the agreement of the trial balance. Only a detailed and intensive checking will reveal these errors.

Detection and prevention of frauds: - It is intentional or willful representation or deliberate concealment of material fact with a view to deceive, cheat or mislead somebody.

Fraud may be broadly classified into three types. They are

(1) Misappropriation of cash

(2) Misappropriation of goods

(3) Manipulation of accounts

Misappropriation, Defalcation or Embezzlement of Cash: - Misappropriation of cash means the fraudulent appropriation of cash belonging to another person by whom it has been entrusted. Misappropriation of cash may take place in any of the following ways:

(a) Suppression or non disclosure of Cash receipts :

The following are examples of suppression of cash receipts:

(1) By misappropriating the receipt by not recording the same in the Cashbook.

(2) By entering lesser amount on the counterfoil and misappropriating The difference between money actually-received and the amount entered on the counterfoil of the receipt book

(3) By not recording the receipt of sale of a casual nature for example Sale of scrap, sale of old newspapers etc.

(4) By omitting to record cash donations received by non-profit making charitable institutions

(5) By misappropriating the cash received on discounting the bills Receivable and showing them as bills outstanding on hand.

(6) By misappropriating cash received from debtors and concealing the same by giving artificial credit to the debtors in the form of bad debts, Discount or sales return etc.

(7) By adopting the method of "teeming and lading" or "lapping process". This is one of the methods of misappropriation of cash. Under this method cash received from the first customer is misappropriated by the cashier. The money received from the second customer is credited to the account of the first customer, the money received from the third customer is credited to the account of second customer, and the money received from the fourth customer is credited to the account of third customer and so on. This process is carried out throughout the year.

(8) By suppressing the cash sales by not recording them or by treating the cash sales as credit sales.

(9) By misappropriating the sale proceeds of VPP sales or sales of Goods on approval basis by treating the transaction as goods Received or not approved.

(10) By under casting receipt side total of the cashbook.

(b) Inflating the payments or showing false cash payments: -

The following are examples of this type of misappropriation:

(1) Recording fictitious or false cash purchases and pocketing the amount.

(2) Inflating the cash purchases and pocketing the difference.

(3) Recording payments to fictitious creditors for purchases and pocketing the money.

(4) Recording the payment to creditors at a figure higher than the actual amount and pocketing the difference.

(5) Recording payments to dummy workers and pocketing the money.

(6) Recording fictitious payments of expenses and pocketing the money.

(7) Recording payments of some accounts at figures higher than the actual payments and pocketing the difference.

(8) By showing credit purchases as cash purchases and misappropriating the amount

(9) Recording personal expenses as business expenses

MANIPULATION OF ACCOUNTS

Manipulation of accounts means falsification of accounts without any misappropriation of cash or goods. It implies presentation of accounts more favorably than what they actually are. Manipulation of accounts may be done in any of the following ways:

(18) Window dressing: - It is the practice by which the balance sheet is made to show a state of affairs that is different from the actual state of affairs. Generally, the practice of window dressing is adopted to make the balance sheet show a state of affairs far better than the actual state of affairs.

3.SPECIFIC OBJECTIVES

There will be specific objective in respect of each type of specific audits. For example, in operational audit, the aim of audit is to evaluate the existing operations of the entity in order to give expert advice to improve their efficiency. The cost audit is to check the cost records of the entity in order to make a report on the proper ascertainment of cost of production of goods or services. Depending upon the nature of specific audit, there may be different objective in respect of each specific audit.

2. INTERNAL CONTROL

Internal control is the whole system of control established by the management for the proper conduct of various activities of the organization. It is not only internal check and internal audit but also the whole system of control financially and otherwise established by the organization in order to carry out the business in orderly and efficient manner.

It is useful for the organization to safeguard the assets and serve the reliability of accounting records. In other words, it is the overall control adopted by the organization.

Features:

1) It is the overall control adopted by the management.

2) It comprises of plans, methods and procedures for the effective control of the operations of the business.

3) It comprises of internal check, internal audit, accounting system and administrative control.

4) It is established by the management.

5) It intended to help the management to run the business efficiently.

Objectives:

1) To ensure that transactions are recorded proper books of account.

2) See that all transactions are carried out only on account of a sanction of authority.

3) See that management policies and decisions are properly implemented.

4) To ensure efficient conduct of business.

5) To evaluate the efficiency of performance of the various personnel.

6) To safeguard the assets of the organization.

7) To safeguard the interest of the organization.

8) To ensure reliability of accounting records.

9) To ensure the periodical verification of assets.

Scope or Area of internal control:

1) Accounting Control. It ensures the reliability of accounting transactions. Accounting transactions are recorded by using accounting principles.

2) Administrative Control. It is concerned with distribution of authority and decision making process of management. Overall operation efficiency of the organization is ensured.

Essentials of Good internal Control:

1) It should be clear and well developed plan of organization.

2) There should be competent and trust worthy personnel for the success of the business.

3) There should be segregation of duties: - Operational duties are separated from recording duties. Physical handling of asset must be separated from accounting records.

4) There should be administrative traditions and practices for the performance of the duties.

5) There should be well developed and adequate accounting system.

6) There should be a sound system of maintenance and recording of accounts.

7) There should be effective internal check system.

8) There should be good audit system.

9) Periodical review of internal control. Advantages.

Advantages Of Internal Control

A. Advantages to the business:

1) Provide accurate and reliable data to the management for taking correct decisions.

2) Ensure that policies and procedures are complied with.

3) Promotes operational efficiency.

4) Help to attain organizational goal.

5) To safeguard the assets of the organization.

6) To ensure the reliability of accounting records.

B. Advantages to the auditors:

1) Helps the auditor in framing the audit program.

2) To ascertain extent of test check can apply.

Limitations of Internal control:

1) Expensive.

2) Transactions of unusual nature may not be subject to internal control.

3) Human errors remain in any system of control.

4) Limitation of preventing frauds committed through collusion between persons.

5) It may not be keep pace with the change in the condition.

3. RIGHTS OF A COMPANY AUDITOR

1) Right of access to books of account of Vouchers: An auditor of a company has a right of access to the books of accounts and vouchers of the company whether they are kept at the head office of the company or elsewhere.

2) Right to examine the cost records: An auditor of a company has a right to examine the cost records along with the quantitative records relating to production, sales, stocks etc.

3) Right to obtain information and explanations: An auditor of a company has a right to obtain from the directors and officers of the company such information and explanation as he may think necessary for the performance of his duties as an auditor.

4) Right to correct any wrong statement: An auditor of a company has a right to correct any wrong statement made by the Directors relating to the accounts to be laid before the company in the general meeting.

5) Right to comment on the inadequacy of the accounting system in his report: If the system of maintaining accounts is inadequate, he can advice the directors to amend the system of accounting.

6) Right to visit branches: The auditor of the company can visit the branch and examine the books and accounts and vouchers at the branch.

7) Right to receive notice and other communications of general meeting: An auditor of a company has a right to receive notice and other communications relating to any general meeting, in the same way as a member of the company.

8) Right to attend the general meeting of the shareholders: An auditor has the right to attend every general meeting of the shareholders.

9) Right to speak at the general meeting: - An auditor of a company has a right to speak at a general meeting where his certified accounts are discussed.

10) Right to sign the audit report: - An auditor has the right to sign the audit report.

11) Right to report to the members of the company: - An auditor has a right to report to the members of the company, if the accounts audited by him show an unsatisfactory state of affairs.

12) Right to report to the members of the company: - An auditor has a right to report to the members of the company, if the accounts audited by him show an unsatisfactory state of affairs.

13) Right to be indemnified: - An auditor of a company, being an officer of the company, has a right to be indemnified out of the assets of the company, for any liability incurred by him in defending himself against any proceedings by the company.

14) Right to receive any remuneration for his audit work: - An auditor of a company has a right to receive remuneration for his audit work provided he has completed the work which he undertook.

15) Auditor's right of lien: - An auditor has particular lien on the books of accounts audited by him for nonpayment of audit fees.

DUTIES AND RESPONSIBILITIES OF A COMPANY AUDITOR

The various duties of an auditor of a company can be grouped into four categories. They are:

(1) Statutory duties.

(2) Contractual duties

(3) Certain duties imposed by legal or court decisions

(4) Duties arising out of professional etiquette.

Statutory Duties: -

Statutory duties refer to the duties imposed by the statute, i.e., by the Companies Act. The various statutory duties of an auditor under the Companies Act are:

(1) Duty to make certain enquiries: - An auditor of a Company should enquire:

1. Whether loans and advances have been properly secured.

2. Whether loans and advances have been shown as deposits.

3. Whether the transactions of the company are not prejudicial to the interests of the company.

4. Whether the personal expenses have been charged to revenue account.

(2) Duty to Report: - An auditor of a company should make a report to the shareholders on the accounts examined by him and balance sheet and profit and loss account.

(3) Duty to comply with the directives of the Central Government: - The Central has been empowered to issue necessary directives to the auditors of certain companies to give specific reports on certain matters. When the central government issues any such directions, the auditors are required to comply with those directives.

(4). Duty to sign his audit report

(5). Duty to give a statement in prospectus: - A prospectus issued by an existing company should contain a statement from the auditor.

(6) Duty to certify the statutory report.

(7). Duty to certify the declaration of the solvency of the company.

(8). Duty to assist Central Government in connection with prosecution.

(9). Duty to make report on public deposits.

4.9.2 The Important Contractual Duties Of An Auditor Are:

1. An auditor has a duty to see that his appointment is in order.

2. He must perform all the duties under common law.

Duties Imposed By Legal Or Court Decisions:

1. An auditor must make himself fully acquainted with his duties under the Companies Act and the Articles of Association of the company.

2. He must not confine himself only to verify the arithmetical accuracy of the balance sheet but should also enquire into its real accuracy and fairness.

3. He should satisfy himself about the valuation of assets.

4. He should perform his duties with great care and skill.

5. It is the duty of a company auditor to check the stock properly.

Duties Arising Out Of Professional Etiquette:

1. Every auditor should carry on his duties with due regard to public interest.

2. An auditor should comply with the rules and regulations formulated by the Institute of Chartered Accountant of India.

3. He must be honest, sincere, technically competent and independent.

4. He should disclose full and fair information about the working and financial position of the company.

PART – B

4. COMPUTER ASSISTED AUDITING TECHNIQUES (CAAT)

Techniques which used computer itself for audit purposes are called computer assisted techniques. The important CAAT are

1) Test data

2) Integrated test facility

3) Controlled processing

4) Computer audit program

Recent trend in auditing or current issues: There are several current issues in auditing. Some of the important current issues or recent trends in auditing are:

1. Audit committees

2. Social audit

3. Inflation audit

4. Human resource accounting and auditing

5. Energy audit

6. Reporting on financial sickness

7. Financial forecast and their audit.

Audit Committees: - An audit Committee is a subcommittee of the board of Directors formed for the purpose of reviewing the annual financial statements before their submission to the Board of Directors, assisting the Board of Directors in discharging their function efficiently and for acting as a liaison between the board of directors and the external auditor.

The setting up of audit Committee has been supported by Stock Exchange, Corporate law authorities, Professional accounting bodies.

The Composition of audit Committee depends mainly up on the nature and the size of the business. An audit committee, generally, consists three to five members.

Functions of Audit Committee are:

1. To consider questions of appointment, resignation, dismissal, remuneration of the auditor.

2. To discuss the nature and scope of duties of external auditor.

3. To review the half yearly and annual financial statements.

4. To discuss the issues and problems arising from the audits.

5. To assist the Board of Directors in the fulfillment of their duties and responsibilities.

6. To evaluate the efficiency of the working of the Board of Directors

Social Audit: -

Social audit is a systematic study and evaluation of a business enterprise's social performance as distinguished from its economic performance. Social audit is intended to evaluate the social performance or social contribution of a business organization

Reporting on Financial Sickness : -

The Sick Industrial Companies are those company which satisfies following conditions:

1. It is an Industrial company.

2. It has been registered for a period of not less than five years.

3. Its accumulated losses at the end of the financial year equal or exceeds its net worth. An auditor is required to assess the financial health of an enterprise, identify initial financial sickness and reporting on the same.

Financial forecasts and their Audit : -

A forecast is a statement of events likely to occur. A financial forecast is a forecast of the financial position of an enterprise in the future. Now a day, certified accountants are required to report on their client's profit forecast and financial forecast.

Inflation audit : -

The accounting which records the effect of changing price is known as inflation accounting. The auditor is required to consider the price level changes recorded in the books of account.

Human resource accounting and auditing: -

It is the accounting and recording of human beings in the organization like other assets. The auditor will be called up on to evaluate the human resource investment.

5. Vouching Of Cash Payments Or Credit Side Of The Cash Book:

While vouching cash payments, an auditor should pay attention to the following points.

1) All vouchers relating to cash payments should be serially numbered and properly arranged.

2) He should insist that the vouchers are properly dated.

3) He should evaluate the system of internal check in operation with regard to cash payments and satisfy himself as to the efficiency of the internal check.

4) He should see that:

a) The cash payments are for the purpose of the business.

b) Payments are related to the period under audit.

c) The payments is properly sanctioned or authorized.

d) The payments are made to the right person.

e) The payments are supported by proper vouchers.

f) The payments are properly recorded in the cash book.

5). Examine the rough cash book items and compare it with the main cash book.

6) See that the payments made are posted to the concerned accounts.

7) See that the amount appears in the vouchers both in words and figures and it agrees with the amount in the cash book.

8) Ensure that the payments have been passed as correct by a responsible official.

Vouching Of Different Items On The Payment Side Or Credit Side Of The Cash Book :

1) Opening credit balance:

The opening credit balance in the bank column can be verified from the previous year's audited balance sheet.

2)Cash purchases:

The vouching of the cash purchases should be on the following lines.

1) The auditor should examine entries in the cash book with the help of cash memos or invoices issued by the supplier and also goods inward book.

2) Special attention should be paid to trade discount, which should be deducted from purchase.

3) See that the cash paid for the goods have actually received.

4) He should see that the purchases are duly authorised.

5) He should see that the amount paid is debited to the appropriate account.

6) To ascertain whether payment made for cash purchases relates to the business.

3) Payments to creditors

Vouching of payment to creditors should be on the following lines.

1) Payments to creditors may be vouched with the receipts issued by the creditors.

2) He should check the amount due to the creditors with the accounts of the creditors.

3) Examine the goods inward book and see that goods have actually been received.

4) The auditor should verify the periodical statement of accounts.

5) In the case of purchase made before the close of the year, see that goods not actually received are kept out of the closing stock of the year.

4) Payment of bills payable

Payment of bills payable on their maturity should be vouched on the following lines.

1) The payment of bills payable, as recorded in the cash book, should be vouched with the bills payable book and also with the bills payable returned by the payees.

2) If the bills payable are through the bank, the auditor should examine the bank pass book for the payment.

3) He should see that bills payable paid and returned by the payees are cancelled.

5) Vouching of loans advanced

Loans advanced should be vouched by the auditor on the following lines.

1) He should see that loans advanced are properly authorised.

2) He should examine the loan agreement.

3) He should vouch the loan advanced as recorded in the cash book with the loan agreement also with the receipt given by the borrower.

4) If the loan is advanced against any security, the auditor should examine the security and its title deeds.

5) Examine the mortgage deed, if the loan is advanced against mortgage.

6) See that the provisions of the companies Act as regards the granting of loans to directors and officers of the company are complied with.

6) Purchase of investment

Vouching of purchase of investment should be on the following lines.

1) The auditor should see that the purchase of investment is properly authorised.

2) If the investments are purchased through a broker, he should vouch the investments purchased with the broker's note.

3) If the investments are purchased through the bank, he should examine the bank pass book to check the payment.

4) He should make a physical verification of the investment purchased.

5) If the investments are purchased cum interest, he should see that the payment made is properly allocated between capital and revenue.

6) See that investments purchased are registered in the name of the client.

7) In the case of accompany, the auditor should see that investments have been purchased in accordance with the provisions of the companies Act.

7) Payment of capital expenditure

The payment of capital expenditure refers to the payment made for the acquisition of the fixed assets such as land & building, plant & machinery, patent, copy right, furniture etc. Vouching of payment of capital expenditure should be on the following lines.

1) The auditor should see that the payment of capital expenditure is properly authorised.

2) He should examine the document pertaining to the purchase and ownership of the fixed assets.

3) He should examine the invoices and the receipts obtained from the suppliers to ensure that payments have been made.

4) He should see that all expenses incurred for the acquisition are capitalised.

5) He should see that repairs and maintenance expenses incurred are charged to revenue account.

6) He should physically examine the fixed assets purchased.

7) He should vouch the cash boom entries for the payment of capital expenditure with the concerned ledger account.

8) See that property purchased is registered in the name of the client.

Vouching Of Payment Made For The Acquisition Of Patents:

Vouching of payments made for the acquisition of patents should be on the following lines.

1) If the patent has been purchased, the auditor should vouch the payment made for the patent with the help of the contract for sale and the receipts for the payment obtained from the seller.

2) If the patent has been purchased through an agent, the auditor should vouch the agent commission with the help of agents account and receipt given by the agent. He should see that the agent's commission is capitalized.

3) He should see that expenses incurred on the purchase of the patent are capitalized.

4) Where the patent is acquired through research, the auditor should see that all the expenses incurred on the experiments and the research connected with patents are capitalized.

5) He should see that payments made towards the renewal fee are charged to revenue account.

6) He should actually see the patent.

Vouching Of Wages:

The object of vouching wages is to ensure that the payment for wages as recorded in wage sheet and cash book, were actually made properly authorised and were correctly maintained. Vouching of payment of wages should be done in the following lines.

1) He should enquire into the system of internal check in force in regard to the maintenance of wage records, preparation of wage sheet and payment of wages.

2) If the internal check is effective, the auditor can conduct the vouching of wages on the following lines.

a) He should check a few items of wage sheets here and there to ensure that the calculations are correct.

b) He should check totals of wage sheet with the cash book.

c) He should see that the amount of cheque drawn for wages tallies with the totals of wage sheet.

d) He should see that deduction from wages have properly adjusted and recorded in the books.

e) He should see that wages recorded in the cash book have actually been paid.

f) He should examine the system of employment of casual labour and check the payment made to casual labour.

g) He should see that proper record is maintained for unpaid wages.

h) Wages for the current months should be compared with the wages of the previous month. If there is a material difference, the auditor should enquire into the reason for the difference.

Vouching Of Salaries:

Vouching of payment made for salary should be on the following lines.

1) An auditor should enquire into the system of internal check in operation in the concern in regard to the payment of salaries.

2) If the internal check system in regard to the payment of salaries is sound, an auditor can conduct the vouching of salaries on the following lines.

a) He should see that the salary bill is prepared with the sanction of a responsible officer.

b) He should see that the salary register is duly signed by each employee and counter signed by a responsible official.

c) He should check the salary register with the entries in the cash book.

d) He should see that the deduction for provident fund, life insurance premium, income tax etc have been correctly made and properly recorded in the books.

e) For vouching salaries of the secretary, manager and other important officials, the auditor should examine the board's minutes book.

f) He should check the attendance register.

g) He should compare the salary bill for the current month with the salary bill of the previous month. If there is any material difference, enquire into the reason for the difference.

h) He should see that the total of the salary book for a particular month agrees with the cheque drawn for salaries.

Vouching Of Petty Cash Book:

Vouching of petty cash book should be on the following lines.

1) He should examine the system of internal check in force in the business in regard to the petty cash transactions.

2) If he finds that the system of internal check is sound, he should adopt the following lines.

a) He should find out find out the system of petty cash book.

b) He should ascertain the name of the petty cashier to the amount of the imprest.

c) He should check some petty cash payments at random with the vouchers to ensure the correctness of the petty cash payments.

d) He should see that all petty cash payments over a certain amount are supported by proper vouchers.

e) He should see that petty cash payments not supported by proper vouchers are supported by slips by the officer who have spent the amounts.

f) See that the petty cash book is periodically checked and initiated by some responsible officer.

g) See that the petty cash balance as shown in the petty cash book agrees with petty cash balance as shown by petty cash account.

h) He should check the casting of total payment column and the individual expenses column.

i) He should physically count the petty cash balances on the balance sheet date. If he fails to do so, he will be held liable for damages. This was upheld in the case of London Oil Storage Company Limited v/s Sears Hasluck and Company.

j) He should see that I.O.Us are not included in the petty cash balances.

Vouching Of Trading Transactions:

Vouching of trading transaction is concerned with credit purchases, credit sales, purchase returns, and sales returns are entered in the purchase book, sales book, purchase return book and sales return book respectively. So vouching of trading transactions also means that vouching of purchase book, sales book, purchase return book, and sales return book. One main object of vouching of trading transaction is to detect misappropriation of goods, if any.

Vouching Of Credit Purchases Or Vouching Of Purchase Book:

The main objective of vouching of purchase book or credit purchases is to ensure that all purchase invoices are entered in purchase book, that goods entered in the purchase book are actually received and the business pays only for those goods which are delivered by the suppliers.

Firstly, an auditor should examine the system of internal check in force in the business in regard to credit purchases. If the system of internal check is not sound, he should check all the entries in the purchase book in detail. If the system of internal check is sound, he need not check all the entries in the purchase book in detail. He has to vouch the credit purchases on the following lines:

1) He should examine the inward invoices from which entries are made in the purchase book. While examining an inward invoice, an auditor should pay attention to the following points:

a) The invoice is in the name of the client.

b) The date given in the invoice relate to the period under audit.

c) The invoice is related to the business in which the concern deals.

d) The invoice is initiated by a responsible officer.

e) The trade discount has been deducted from the amount of invoice and then only net amount has been entered.

f) Quantity mentioned in the purchase invoice tallies with the quantity recorded in the purchase book.

2) He should check the purchase invoices with the purchase book, where the credit purchases are recorded.

3) He should see that only credit purchases are recorded in the purchase book.

4) He should see that purchases not made for the business are not recorded in the purchase book.

5) He should see that purchases of capitals assets are not included in the purchase book.

6) He should see that all goods received prior to the date of closing and taken into stock are recorded in the purchase book.

7) He should see that goods entered in the purchase book but not received are included in the closing stock.

8) He should verify some of the purchase invoices with the goods inward book, stock records and the challans from the suppliers to see that the goods have actually received.

9) He should compare some of the entries in the purchase book with the order book and goods inward book to ensure that no fictitious purchases are recorded and no invoice is entered twice.

10) To ensure that all invoices are included in the purchase book, the auditor should obtain the statement of accounts from the creditors and examine them.

11) He should make a list of all invoices missing or not available.

12) Where contracts for forward purchases are entered into, the auditor should see that they are not abnormal. If they are abnormal in amount, he should see that it is mentioned in the balance sheet by way of note.

13) He should check the casts and carry forwards to the purchase book.

14) He should check the postings from the purchase book to the purchase account as well as to the creditors account.

15) He should check carefully the purchase made in the first month and the last month of the accounting year, because, sometimes, purchases made in the last month of the last year may be included in the purchase of the current year or purchase made in the last month of the current year may be included in the purchases of the first month of next year.

Vouching Of Credit Sales Or Vouching Of Sales Book:

Outward invoices, which are the vouchers for the credit sales, are not completely reliable, as they are prepared by the staff of the business. So an auditor has to very careful in vouching credit sales. Firstly he should examine the following lines:

1) He should examine the outward invoices from which entries are made in the sales book. While examining the outward invoices, he should pay attention to the following points:

a) See that name of the customer stated in the outward invoice agrees with the entry in the sales book.

b) The date given in the outward invoice relate to the period under audit.

c) The invoice is initiated by a responsible officer.

d) See that trade discount allowed is deducted from the sales price and net amount has been entered.

2) He should check the outward invoices with the sales book, where the credit sales are recorded.

3) He should check the sales book with the order received book and see that the sales are genuine and all the sales are included in the sales book.

4) After the examination of outward invoices, the auditor should see that they are cancelled by stamping out and all the cancelled invoices are kept together for verification.

5) He should see that only credit sales are recorded in the sales book.

6) He should see that sales of capital assets are not included in the sales book.

7) See that good sent on sales or return or on consignment are not entered in the sales book.

8) He should see that good sold, but not delivered are not included in the closing stock.

9) He should check the casts and carry forwards of the sales book.

10) He should check the postings from the sales book to the sales account and customer accounts in the ledger.

11) He should check carefully the sales made in the first month and the last month of the accounting year, because, sometimes, sales made in the last month of the last year may be included in the sale of the current year or sale made in the last month of the current year may be included in the sales of the first month of next year.

12) If the trade discount allowed during the current year is exceptionally high, the auditor should enquire in to the reasons for the same.

13) Where the sales are subject to sales tax, the auditor should see that the sales tax collected is separated from the sales price, and is shown in a separate column in the sales book.

14) Sometimes, fictitious sales are included in the sales book to inflate the sales and the gross profit, an auditor has to take necessary steps to discover such fictitious sales.

Vouching Purchase Returns Or Purchase Returns Book:

An auditor should undertake vouching of purchase returns on the following lines:

1) He should enquire into the system of recording of purchase returns.

2) He should vouch the purchases returns book with the credit notes received from the creditors.

3) He should examine the goods outward book and the related correspondence to ensure that there is no suppression of purchase returns.

4) He should check the casts and carry forwards of purchase returns book.

5) He should check the postings from the purchase returns book to the purchase returns account and customers account in the ledger.

6) He should check carefully the entries in the purchase returns book for the first month and for the last month of the year to ensure that there is no manipulation of accounts.

Vouching Of Sales Returns Or Sales Returns Book:

1) He should enquire into the system of recording sales returns.

2) He should vouch the sales returns book with the credit notes issued.

3) He should examine the goods inward book and the related correspondence to ensure that there is no suppression of sales returns.

4) He should check the casts and carry forwards of sales returns book.

5) He should check the postings from the sales returns book to the sales returns account and customers account in the ledger.

6) He should check carefully the entries in the sales returns book for the first month and for the last month of the year to ensure that there is no manipulation of accounts.

6. Secret Reserve:

The term secret reserve refers to a reserve the existence of which is not disclosed in the Balance Sheet. Secret reserves are also called ***Hidden Reserve*** or ***Internal Reserve***. Such a reserve is not disclosed on the Balance Sheet. It can be said that there is a surplus of assets over liabilities and that surplus is not disclosed or shown by the Balance Sheet.

Method of Creation of Secret Reserves

Secret reserves may be created in the following ways:

1. Providing excess depreciation on fixed assets such as plant, machinery, land & building, furniture and fixtures, etc.

2. Writing down an asset completely.

3. Understating goodwill.

4. Undervaluing assets such as stock, investments, etc. and showing them much below their cost or market value.

5. Non-recording of permanent rise or appreciation in value of a fixed asset, e.g., buildings.

6. Providing excessively for bad and doubtful debts..

7. Overvaluing liabilities.

8. Including of fictitious liabilities.

9. Showing contingent liabilities as real liabilities.

10. Suppression of accrued income and prepaid expenses.

11. Making excess provision for expenses.

Objects of Creating Secret Reserve

The inherent ideas of creating secret reserve are as follows:

1. Maintaining a strong financial position.

2. Improving the solvency position of the entity.

3. Meeting sudden future financial losses.

4. Facing competitions.

5. Confusing the rivals regarding profitability.

6. Providing additional working capital.

7. Maintaining a stable dividend payment.

8. Hiding a portion of profit.

9. Enabling the directors to tide over unfavorable time.

10. Helping the management not to distribute the hide portion of profit, which is retained in the business in the form of secret reserve to the shareholders in the interest of the business.

PART – C

7.a. DISTINCTION BETWEEN AUDITING VS ACCOUNTING:

Points of difference	Accounting	Auditing
1. Meaning	It is recording of all the day to day transactions in the books of accounts leading to preparation of financial statements.	It is the critical examination of the transactions recorded in the books of accounts.
2. Nature	It is concerned with finalization of accounts.	It is concerned with establishment of reliability of financial statements.
3. Objects	The object is to ascertain the trading results.	The object is to certify the correctness of financial statements.
4. Commencement	Accounting Commences when book keeping ends.	Auditing begins when Accounting ends.
5. Scope	It involves various financial statements. It involves maintenance of books of accounts.	It depends upon the agreement or upon the provisions of law. It goes beyond books of accounts.
6. Report	An accountant is not required to submit any report to the proprietor of the business.	An auditor is required to submit a report to the proprietor of the business.
7. period	Accountancy work is conducted continuously throughout the year	Auditing work is generally, conducted at the end of the year or periodically.
8. Qualification	An accountant, who is in charge of accounting work, need not be a qualified person.	An auditor, who is in charge of auditing work, must be a qualified person.

b. VOUCHING OF CASH PURCHASES:

The vouching of the cash purchases should be on the following lines.

1) The auditor should examine entries in the cash book with the help of cash memos or invoices issued by the supplier and also goods inward book.

2) Special attention should be paid to trade discount, which should be deducted from purchase.

3) See that the cash paid for the goods have actually received.

4) He should see that the purchases are duly authorised.

5) He should see that the amount paid is debited to the appropriate account.

6) To ascertain whether payment made for cash purchases relates to the business.

c. REMOVAL OF AN AUDITOR

An auditor may be removed before the expiry of the term for which he has been appointed. The first auditor appointed by the directors of the company may be removed before the expiry of his term of office and another person may be appointed in his place by the shareholders at a general meeting by passing an ordinary resolution to that effect. A subsequent auditor appointed by the shareholders at an annual general meeting can be removed from the office before the expiry of his term of appointment by the shareholders in general meeting by passing an ordinary resolution after obtaining previous sanction of the central govt.

For the removal of any auditor before the expiry of his term of office and for the appointment of another auditor in his place, in the following procedure has to be followed: First, a special notice of the days containing the proposed resolution to remove an auditor before the term of office and to appoint a new auditor in place must be given to the company by any member interested. On receipt of the notice of such resolution, the company must send a copy of the resolution to the auditor who is sought to be removed. After receiving a copy of the proposed resolution, the auditor concerned can make his representation to the company. There after, if the members desire that the auditor should be removed before his term of office and another person should be appointed in his place, an ordinary resolution should be passed by the share holders at the general meeting. It may be noted that for the removal of a subsequent auditor, the provisions approval of the central government also must be obtained.

d. Advantages Of Audit Programme

The advantages of Audit Programme are:

1. Provides a clear set of instruction on the work to be done.
2. Provides clear record of work done and by whom.
3. Work can be reviewed by senior auditor.
4. Work will not be duplicated.

5. No important work will be overlooked.

6. Evidence of work done is available for use in defending charge for negligence.

7. Audit Programme serves as a shield against any charge of negligence by a client on the part of the auditor.

8. It provides an assurance that no material aspect of audit examination has been overlooked.

9. It pinpoints the audit work to be done by audit staff and that has already been done.

10. IT facilitates in the distribution of work among the audit staff according to their knowledge.

11. Audit programme of last year serves as a basis in preparing the audit programme for subsequent year.

12. Before signing the audit report, final review of work done can be easily made.

13. It ensures the adherence to International Accounting and Auditing Standards.

14. Responsibility of each audit staff (articled clerk) is fixed.

e. CAUSES OF DEPRECIATION:

(i) Use of the Assets or Wear and Tear:

The main cause of depreciation is the wear and tear of assets when they are put to use in the enterprise. It reduces the future technical capacity as well as earning power of the asset with the result that it brings reduction in the value of asset.

(ii) Accident:

Another important contributing factor to depreciation is accident such as plant break down, loss by fire, etc.

(iii) Expiration of Certain Legal Rights:

In case of patents, leases and licenses depreciation is a time function as by the expiration of time for which legal right to use is created lapses.

(iv) Obsolescence:

Because of technological developments, the asset in use may become outdated and lose a large part of its value. This fall may also be the result of changes in tastes and habits of customers, changes in the supply and location of material resources, etc.

(v) Inadequacy:

Sometimes there may be a necessity of putting the assets out of use despite the fact that the asset is in good physical condition. It is because of inadequacy. Inadequacy refers to the termination of the use of an asset because of growth and changes in the size of the firm. For the needs of the firm the asset may not be adequate and another firm of small size may buy it.

(vi) Depletion:

Where the asset is of wasting character, due to the extraction of some materials, such as mines, forests, quarries and oil wells, the asset will be depleted.

f. DISQUALIFICATION OF AN AUDITOR

Certain persons are disqualified from being appointed as auditor of a company. They are:

(1)A body corporate

(2)An officer or employee of the company

(3) A person who is a partner or who is the employment of an officer or employ of a company.

(4) A Person who is indebted to the company for an amount exceeding RS1000.

(5) A director or a member of a private company.

Besides the above disqualification, certain additional disqualifications are also prescribed by the companies (Amendment) Bill 2003. These are:

(1) An auditor who has any direct financial interest in the company.

(2) An auditor who received only loan or guarantee from or on behalf of the company.

(3) An auditor who has any business relationship in the company.

(4) An auditor who has been employed in the company

(5) An auditor whose relative is in the employment of the company

g. Appointment Of First Auditor:

The first auditor of a company is appointed by the Board of Directors within the month of the Registration of the company. The first auditor, appointed by the Board of Directors will hold office till the conclusion of the first annual general meeting of the company. If Board of Directors fails to appoint the first auditor, the company may appoint the first auditor in the general meeting. The first auditor appointed by the shareholders in the general meeting, will also be reappointed at the first annual general meeting of the company

PART – D

8.a. Primary Objective or Main Objective:

Expression of expert opinion: - The main objective of auditing is to verify the accounts and records and to report to the owners of the business whether the profit and loss account and the Balance sheet have been properly drawn up according to the requirements of law, and whether they exhibit a true and fair view of the profit and the financial position of the business.

To ensure that the primary objective of audit is achieved, an auditor must:

(a) Examine the Internal Control and Internal Check.

(b) Verify whether all the books of accounts as required by law are kept.

(c) Verify whether proper accounting principles and procedures are followed.

(d) Check the arithmetical accuracy of the books of accounts.

(e) Verify the authenticity and validity of the transactions.

(f) Confirm the existence and the values of the assets and liabilities by physical verification.

(g) Find out whether the financial statement is properly drawn up.

(h) Report whether the profit and loss gives a true and fair view of the profit or loss for the year and Balance sheet gives a true and fair view of the financial position of the business at the end of the financial year.

b. Internal audit:

Internal audit is a continuous and systematic review of the accounting, financial and other operations of a concern by the staff specially appointed for the purpose. In other words, it is the audit of accounts by the staff specially appointed for the purpose.

c. Balance sheet audit :

Balance sheet audit is a type audit which concentrates mainly on the verification of the items in the balance sheet such as capital, reserves, profit and loss account balance, liabilities and provisions and all the assets of the business.

d. AUDIT NOTE BOOK

During the course of audit the audit clerk experiences several difficulties. He cannot remember everything at all time. So he maintains a book with him in which he makes note of important points and queries, which he has to refer to the client's staff or clarify with the chief auditor. Such a book is called Audit Note Book.

e. ROUTINE CHECKING:

It is the checking and casting common books of accounts by the auditor. It involves following activities.

a) Checking, casting and sub casting of such books.

b) Checking of posting into ledger book.

c) Checking the balances transferred from one book to another Common Books. Sales ledger, private ledger, wage sheet , general ledger, debit note, credit note, all subsidiary books like cash book, purchase book, journal proper etc..

f. VERIFICATION OF ASSETS AND LIABILITIES

Verification means 'proving the truth' or 'confirmation of the truth'. Verification of assets and liabilities means proving the truth about the existence and the correctness of the money value of the assets and liabilities appearing in the balance sheet of the business. In other words, it means establishing the actual existence of the assets and liabilities appearing the balance sheet, ownership and possession of the assets and proper classification and valuation of assets and liabilities.

g. VALUATION OF ASSETS

Valuation of assets means the determination of or the ascertainment of the money value at which the assets are shown in the balance sheet. However in audit it implies critical examination and testing of the determined values of the assets on the basis of generally accepted accounting principles. In short, it is the process of ensuring that the money value of the asset as shown in the balance sheet has been properly determined.

h. DEFINITION OF 'WASTING ASSET'

An item that irreversibly declines in value, as a function of time. Wasting assets include vehicles, machinery and other fixed assets. Accountants attempt to quantify the amount that assets decrease in value over time, by assigning depreciation schedules to wasting assets, therefore, recognizing the decrease in value each year.