# SYLLABUS

## B.Com - III Year

## Subject – Auditing

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|---|---|
| UNIT – I | Introduction: Meaning and Objectives of Auditing. Types of Audit, Internal Audit.<br>Audit Process: Audit Programme, Audit and book, working papers and evidence, Preparation before commencing of Audit. |
| UNIT – II | Internal Check System: Routine Checking, Internal Check and Test Checking.<br>Internal Control and Audit Procedure. |
| UNIT – III | Vouching, Verification of Assets and Liabilities |
| UNIT – IV | Company audit: Appointment of auditor, Powers, Duties and Liabilities. Divisible Profits and Dividend. Auditor's report: Cleaned and Qualified report. |
| UNIT – V | Investigation: Objectives, Difference between audit and investigations, Process of Investigation. Special audit of Banking Companies, Educational, Non Profit Institutions and Insurance Companies. |

**UNIT-I**

**Meaning of Auditing -** According to AAS-1 An audit is an independent examination of financial information, of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to, expressing an opinion thereon.

The person conducting audit is know as the auditor, he makes a report to the person appointing him after due examination of the accounting records and the accounting statement in the form of an opinion on the financial statements. The opinion that he is called upon to express is whether the financial statement reflects a true and fair view.

A complete and comprehensive definition : "Auditing is a critical examination of the books of accounts of an organization, which is conducted by an independent individual skillfully on the basis of vouchers and other information, with an object to reporting that the profit and loss account prepared for a certain period expresses the true and fair profit or loss of the organization and the balance sheet of the organization, prepared on a certain date, depicts a true and fair picture of the financial position of the organization on the particular day".

**Definition**

R.B. Bose : "Audit may be said to be the verification of the accuracy and correctness of the books of accounts by an independent person qualified for the job and not in any way connected with the preparation of such accounts.

**Advantages of an Audit**:

(a) Safeguards the financial interest of persons who is not under management of the entity, i.e., partners or shareholders.
(b) Acts as a moral check on the employees from committing frauds and errors.
(c) Helpful in setting liability for taxes, negotiating loans and determining the purchase consideration for a business.
(d) Useful for setting trade disputes whether it is a matter of performance bonus or increment or it is claim for the damages due to fire or other accident.
(e) Discover the areas of wastages and losses occurring due to the absence or inadequacy of internal checks or internal control measures.
(f) Audit report generally state the fact that whether proper books of account and related records have been properly kept so as to make the deficiencies or inadequacies good in this respect.
(g) As an appraisal function, audit reviews the existence effectiveness and continuity of various controls in the organizations and reports weaknesses, inadequacies, etc., in them.
(h) Audited accounts are of great help in the settlement of accounts at the time of admission or dissolution or death or retirement of partner.

**The objectives of audit:**

1. Examination of the Truth and Fairness of Final Accounts :
2. Discovery of Errors :
3. Detection of Fraud :
4. Prevention of Frauds and Errors :
5. Advice to Management :
6. Ascertaining true Financial Position of Business :
7. Objectives determined by International Auditing Practices Committee :

**Types of Audit**

(1) On the basis of need of audit

a. External Need b. Internal Need

(2) On the basis of period of audit

(a) Continuous Audit (b) Interim Audit (c) Final/Annual Audit

1. **On the basis of Need**

a. The auditor appointed to satisfy the internal or managerial needs of the organization is known as INTERNAL AUDITOR. According to AAS-7 The internal audit function constitutes a separate component of internal control established with the objective of determining whether other internal controls are well designed and properly operated.
b. The auditor appointed to satisfy the External Needs of the organization is known as EXTERNAL AUDITOR.
c. If external need is a statutory need the same external auditor is known as STATUTORY AUDITOR. For example :

2. **On the basis of Period of Audit**

A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or his staff attends at regular or irregular intervals during the period.

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

(a) It is carried throughout the year.
(b) It is conducted at regular or irregular intervals depending on auditors professional judgment.
(c) The accounts are taken for scrutiny as and when prepared.
(d) Final accounts i.e. trial balance, profit and loss account and balance sheet are audited at the end of the year.

**Advantages of Continuous Audit**

(i) Exhaustive and intensive.
(ii) Greater possibility of exposure of errors and frauds.
(iii) Early detection of errors & Frauds.
(iv) Moral impact on employees.
(v) Quick preparation of final accounts.
(vi) Early planning for future.
(vii) Proper advice of auditor
(viii) Early rectifications of errors.

(ix) Facility for interim accounts.

**Disadvantages of Continuous Audit**

(i) Possibility of change in audited accounts.
(ii) Snags in routine work.
(iii) Adverse moral impact
(iv) More expensive
(v) Dislocation of sequence of work.
(vi) Mechanization of work
(vii) Sloth in work.

**Annual Audit** : Annual audit is one which is carried out only at the end of an accounting period, spicer and pegler have defined it as. An audit which is not commenced until after end of the financial period and is then carried on until completed. Annual audit is also called periodical, final or completed audit.

**Characteristics**: The main Characteristics of annual audit are as follows :

(a) It is done at the close of the financial year books of account have been closed and final accounts drawn by the management of the entity.
(b) The audit work is completed at a stretch i.e. in a single continuous session.
(c) Generally this type of audit suitable to small organizations.

**Interim Audit** : An audit conducted between two annual audits is called interim audit. More commonly it is known in case of banks as half yearly review. Interim audit helps management to take timely and appropriate decisions for example declaration of interim dividend or valuation of shares to decide swap ratio in case of a merger. Interim audit is gaining statutory status now a days various regulating authorities like SEBI and RBI requires periodic audited financial statements in between the to annual audited financial statements. However, it is generally carried out by professionally qualified auditors.

**Limitations of Audit**

1. Auditing does not guarantee 100% correctness.
2. All frauds are not necessarily disclosed by audit.
3. The auditor expresses only his opinion.
4. Auditing is not a credential of the perfect honesty of employees.
5. Auditing does not certify the commercial prudence of transactions.
6. Auditing does not pay attentions to trivial.
7. Auditing is not supported by practical independence.

**Rights of Auditors [Section 227]**

1. Rights of Auditors to access books of accounts An auditors of a company shall have a right of access **at all times** to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.

2. **Right to obtain information and explanations {227(1)}**

   An auditor of the company is entitled to require from the officer of the company such information and explanation as he may think necessary for the performance of his duties as an auditor.

3. **Right to visit branch offices and access to branch account [Sec. 228(2)]**

   Where the accounts of any branch office are audited by a person other than the company's auditor, the company's auditor is entitled to visit the branches, if he deems it necessary to do so for the performance of his duties as an auditor.

4. **Right to receive notice and attend general meeting [Sec. 231]**

   The auditor has the right of

   - receiving all the notices and other communication relating to any general meeting of a company which any member of the company is entitled to have
   - He is entitled to attend any general meeting and
   - He is entitled to be heard at any general meeting which he attends on any part of the business which concern's him as an auditor.

5. **Right to make representation [Sec. 225]**

   The retiring auditor is

- entitled to receive a copy of the special notice intending to remove him or proposing to appoint any other person as auditor.
- Further, the retiring auditor sought to be removed has a right to make his representation in writing and request that the same be circulated amongst the members of the company.
- In case, the same could not be circulated, the auditor may require that the presentation shall be read out at the general meeting. The auditor also has the right to be heard at the general meeting.

6. **Remuneration of the Auditor [Section 224(8)]**

   Auditor is entitled to receive remuneration as follows

   a. **Where appointed by the Board of Director**
      When an auditor is appointed by the Board of Directors, remuneration is also fixed by them.

   b. **Where appointed by shareholders:**
      In this case the remuneration is determined by the share holders at the AGM.

   c. **If appointed by the Central Government**
      In this case the remuneration is fixed by the Central Government.

   d. **If appointed by the Comptroller and Auditor General of India: the remuneration should be fixed by the co. in general meeting.**

7. **Right to correct any wrong statement**

8. **Right to have legal and technical advice.**

**Duties**

1. Duty as to enquiry [Sec. 227(1A)]:
   Without prejudice to the rights given under s. 227 (1) auditor must enquire into following matters:

   (a) Whether loans and advances made by the company on the basis of security:
      (i) have been properly secured and
      (ii) whether the terms on which they have been made are not prejudicial to the interest of the company or its members;
   (b) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;
   (c) Whether the company is an investment company or a banking company, whether so many of the assets of the company as consists of shares, debentures and other securities have been sold at a price less than at which they were purchased by the company;
   (d) Whether loans and advances, made by the company have been shown as deposits;
   (e) Whether personal expenses have been charged to revenue account; and
   (f) Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether the cash has actually been so received, whether the position as stated in the accounts books and the Balance Sheet is correct, regular and not misleading.
2. To report to members.
3. To specify a few things in the report.
4. Duties under section 227(4A).
5. To report for inclusion in prospectus.
6. To certify the Statutory Report.
7. Duties regarding Investigation.
8. To submit report on the Balance Sheet and P. & L. Account appended to the declaration of solvency at the time of voluntary winding up.

**Liabilities of An Auditor**

**A. Civil Liabilities** **B. Criminal Liability**

**(A.) Civil Liabilities**

**1. Liability for Negligence: -**

If the auditor owes some duty towards the plaintiff (the person who files a suit in the court), and he does not discharge his duties with reasonable skill and care, resulting in a loss to the plaintiff, the auditor is guilty of negligence.

**2. Liability for Misfeasance:**

If the auditor does not approach and perform his duties it is misfeasance an auditor is liable to indemnity only if the following things are proved against him:

(i) The auditor owned duty to the plaintiff:
(ii) He failed to discharge his duty;
(iii) The plaintiff suffered loss due to non-performance of duty by the auditor.\

3. **Civil Liability under Indian Companies Act:**

**a. Under section 62:** If an auditor who can also be the auditor of the company gives untrue statement as expert in the prospectus issued by the company, he is liable to indemnify to each person who, believing the prospectus applied to purchase any shares or debentures and who has suffered loss due to the untrue statement.

**2. According to Section 543 of Indian Companies' Act:** The Court can compel an auditor to indemnify the company an amount deemed fit by the Court with regard to the being wound up, if he is held guilty of misfeasance and breach of trust.

**Civil Liability towards Third Party:**

1. **Not liable for negligence:** In regard to civil liabilities an auditor can be compelled to indemnify only if the auditor owed duty towards the plaintiff. Regarding company audit, as already stated, an auditor is appointed by company, therefore, he owes duty only to the company. If loss is suffered by third party due to negligence or misfeasance of the auditor, the auditor cannot be liable for it. It is only just because there is no contract between the auditor and third party.
2. **Liability for fraud:** An auditor is not liable to third party for negligence or misfeasance but if he is guilty of fraud, he shall be held liable to the third party also.

**B. Criminal Liability**

**Criminal Liability under Companies' Act**

1. Violation of section 57.

2. Not signing authenticating as per the Act.

3. For not rendering help to the Inspector.

4. Fraud in books. (Sec. 539)

5. Filing a suit for a criminal action.

6. For false statement in a report.

7. For untrue statement in the prospectus.

8. For prompting a person to invest.

9. For false evidence.

10. Arresting and producing the auditor in the court.

## Audit Process

**The steps in audit process are :**

1. Appointment of auditor
2. Determination of Objective and Scope of audit
3. Obtaining Knowledge of Clients business
4. Evaluating accounting system, Internal control and Audit risk.
5. Audit Planning and programming, Determining the nature timing and extent of audit procedure and co-ordination of work.
6. Collection of audit evidence
7. Drawing conclusions and making report.

## Preparation of Audit Programme

Audit programme is a description, memorandum or outline of the work to be done in an audit and often of the time allotted and personnel assignments, prepared by a Principal as a definition of audit scope, or by an auditor for the guidance and control of assistants. It is the auditors plan of action, specifying the procedures to be followed.

**Objects of audit programme** :

a. To obtain informations regarding the accounting system, policies and control techniques of the client.
b. To ascertain the extent to which internal control techniques can be banked upon.
c. To lay down the nature, time and extent of audit techniques to be adopted.
d. To co-ordinate the total work.

## Characteristics of good audit programme

i. Explicit and clarity of expression.
ii. Segmentation of work in the light of different aspects of accounting.
iii. Logical flow of accounting documents
iv. Elasticity
v. Review of work
vi. According to scope of audit
vii. Based on evidences
viii. Record of movements and accomplishments.

| Advantages of audit programme : | Disadvantages |
|---|---|
| i. Division of work as per ability | i. Mechanisation of work |
| ii. Determination of responsibilities | ii. No motivation for free decision |
| iii. Progress of work | iii. Want of constructive thinking |
| iv. Change of employees won't affect work | iv. Want of moral influence |

v. Uniformity in work

vi. Protection in court of law

vii. Complete examination

viii. Time saver

ix Facility of review

x. Pursuance of audit principles

v. Planned frauds are undisclosed

vi. Disabilities remain concealed

vii. Plea against auditor

**Audit working papers**

Audit working papers are personal written materials which an Auditor prepares with regard to all audits and contains techniques adopted by the auditors, his decisions and conclusions and relevant information regarding financial statements.

Some papers included in Audit Working Papers;-

1. The agreement regarding the appointment if the auditor or letter of appointment
2. Technical Features of the audited business.
3. Audit Programme
4. Certificates of officials in regard to such important matters as bad debts, valuation of stock, unpaid expenses, accrued income etc
5. Certificate issued by the banks in regard to the bank balance of the client certain date, safe custody of documents etc.
6. Correspondence between the auditor and the debtors, creditors, etc. the client.
7. Rough trial balance.
8. Important extracts from the minute books
9. Particulars of investment.
10. Draft final accounts.
11. A copy of the auditors book.

**Objects of keeping Audit-Working Papers;-**

1. Certification of the correctness of record and report
2. Use as references, during discussion with the employer.
3. Defensive position of the auditor in case of legal dispute and court proceedings.
4. Guide for Subsequent examinations.
5. To co-ordinate and organize the work of audit clerks.

**Ownership of Audit-Working Papers :-**

These are the property of the auditor, whether prepared by him or presented to him by the owner of the business and therefore must be kept in safe custody.

Filing of Audit-Working Papers is a necessity. The auditor keeps these papers for his defense, reference, future guidance and as a proof of his. According to section 209 of the Indian Companies Act 1956, the books of accounts of a company must be kept safe up to 8 years after the relevant year.

**Audit Note Book;-**

An important component of Audit-Working papers is audit note- book basically maintained by the audit clerk in which he notes down the important points and enquires which he has to refer to officials clients or to discuss with his senior or the auditor himself.

Contents of audit note book:

1. Technical details about the business.
2. Queries for which explanations and information have to be demanded.
3. Missing vouchers and invoices whose duplicates have to be obtained.
4. Fraud and errors found in the books during the course of audit.
5. Details to be included in audit report.
6. Notes regarding system of maintaining accounts.
7. Information to be needed in future.
8. Names of officials who certify bad debts, depreciation, etc.
9. Record of all important correspondence.
10. Total of important ledger accounts.
11. Progress of audit work.
12. Record of suggestions made by the audit staff.

**Advantages:-**

1. Defense in court of law.

2. Yard-stick of the efficiency and diligence and skill of the auditor,

3. Guide for future.

4. Future references,

5. Permanent certificate of audit.

UNIT-2

INTERNAL CHECK SYSTEM

**ROUTINE CHECKING:**

Regular checking of all the daily transactions is known as Routine Checking. Routine checking incorporates the following tasks:

- Checking of record in primary books, costing, transfer etc.
- Checking transfer of transactions from original books of accounts to ledger account.
- Checking debit and credit side of various accounts.
- Checking transfer of balances of various accounts to other pages or accounts or statements.

Various signs are used while conducting routine check. Such signs provides the proof of routine checking of transactions.

Signs which are used in audit should be small and clear. Generally red or pink color is used while conducting routine check. But green color is used while conducting final audit.

***Advantages Of Routine Checking***

*Following benefits can be obtained from the routine checking:*

1. All the original entries will be checked; so all the errors and frauds can be detected easily.
2. All the entries and posting will be tested.
3. Routine checking helps to conduct final audit because all the balancing and totals have already been checked.
4. Separate and specific staffs are not needed because it is a regular process.

***Disadvantages Of Routine Checking***

*Followings are the limitations of routine checking:*

1. Routine checking is a mechanical test, so the staff who performs this work does not have inspiration. So, there are chances of leaving errors and frauds.
2. Routine checking can only detect small errors and frauds but not the planned frauds.
3. Routine checking is not needed where self balancing system is applied.
4. Routine checking cannot detect principle and compensating errors.

**INTERNAL CHECK**

Internal check means that check imposed in such a way on a day to day transaction that work of one person is checked by another person automatically in this way the chances of frauds and errors minimizes.

Objects of Internal Check:

i. Prevention of Fraud
ii. Prevention of Error
iii. Swift discovery of fraud and error
iv. Fixing the responsibility
v. Correct accounting of business transactions
vi. Fast preparation of Final Accounts
vii. Facility of Audit work.

Essential features of Ideal Internal Check System:

| | | |
|---|---|---|
| 1. | Regarding Employees | i. Qualification and Training<br>ii. Honesty and Integrity<br>iii. Security<br>iv. Monitoring<br>v. Fixing Responsibilities<br>vi. Allocation of Work<br>vii. Authorization<br>viii. Compulsory Leave |
| 2. | Regarding Accounting | i. Sound System of Accounting<br>ii. Procedure Manual<br>iii. Forms |
| 3. | Other Features | i. Utilization of Machinery<br>ii. Control over mailing<br>iii. Flexibility. |

Advantages of Internal Check:

i. Cautious Employees
ii. Honest Employees
iii. Moral Impact on Work Environment
iv. Elimination of Errors
v. Minimum Frauds
vi. Early discovery of errors and frauds.
vii. No cumulative effect on business
viii. Fast preparation of final accounts
ix. Facility to Auditor
x. Responsibility Fixing
xi. Substitution of Audit
xii. Relief for businessman.

Disadvantages of Internal Check:

i. Expensive
ii. Repetition
iii. Negligence of Owner
iv. Adverse effect on Employees
v. Negligence of Auditor
vi. Frauds through Collusion.

Internal Check Systems in different Business Transactions:

i. Purchase of Services, Assets and Goods
ii. Sale of goods.
iii. Cash Receipts
iv. Cash Payments
v. Internal Transactions

**TEST CHECKING**:

Test checking is a substitute for detailed checking. It involves only a partial checking. The auditor normally does not check completely all the records made into the books of accounts but, through a process of sampling, selects a few items and if they are found correct, he presumes that the remaining entries would also be correct likewise.
Thus, the whole system of test checking implies selecting and checking only a few selected transactions so as to enable the auditor to form his final judgment as to the whole set of transactions.

As stated above, in applying 'test check', the selection of transactions is made by the auditor at random and no specific principles are followed in it. The choice for adoption of testing methods is fully dependent on the discretion and judgment of the auditor who will depend on the situation of individual cases.

The use of test checking is, however, dependent upon the system of internal check in operation. If this system is satisfactory, test checking can be of immense help to the auditor.Where there is an efficient system of internal check and the business maintains a separate staff for internal audit, test checking can be a very reliable device to carry on the work of audit.

But it should be kept in mind that if the system is reliable and test check is applied but mistakes are detected, a thorough checking of books would provide an answer. Thus, given an efficient system of internal check in operation, test checking can reduce the volume of work involved in audit.

Test checking should be applied and carried out intelligently and carefully, otherwise, it may lead to dangerous consequences. But much will depend on the system of internal check and the intelligence of the auditor.

Advantages:

i. Time Saving
ii. Correct Results
iii. Utilization of Saved Energy
iv. Suitable for large size enterprise.
v. Adds to the significance of Internal Check.

Disadvantages:

i. Undisclosed errors and frauds.
ii. Incredibility and unauthenticity.
iii. Enhancement of Auditor's Liability
iv. Negligent Employees
v. Continuance of vicious circle.

## INTERNAL CONTROL

### Meaning of Internal Control

Internal control comprises all the measures whereby every aspect of business is controlled. A businessman wants to control the internal functions of the business in such a way to maximize profits and reduce to a minimal level the possibilities of errors, frauds, and embezzlement. For such a situation, the businessman controls each and every aspect of the business in a planned manner. Such a measure at the organisational level is called internal control. It helps to control all sorts of business activities, financial as well as administrative. The following definition by W.W. Bigg explains internal control in clear terms. "Internal control is best regarded as indicating the whole system of controls, financial or otherwise established for the conduct of business including internal check, internal audit and other forms of control.

Internal control can be defined as control of enterprise over its business. Every policy, standard procedure, system, rules, plans, introduced with the sole objective of establishing the control is known as internal control. Internal control is all pervasive and not confined to accounting system only. Internal control system is defined as-

All the policies and procedures (Internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable,

- The orderly and efficient conduct of its business, including adherence to management policies,
- The safeguarding of assets,
- The prevention and detection of fraud and error,
- The accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

### Objects of Internal Control

1. Correct accounting of Transactions
2. Prevention of Error and Fraud
3. Fixing responsibilities
4. Safety of assets
5. Efficiency and improvement in performance
6. Provide aid in management planning
7. To encourage and measure how far policy of business is being implemented

## Internal Audit

Internal auditing is the independent appraisal activity within an organisation for the review of the accounting, financial and other operations as a basis for productive and constructive service to management. It is conducted by regular employees of a business concern.

**Objects of Internal Audit**

1. To assure the effect of internal check.
2. To see that transactions are authorised
3. To discover frauds.
4. To prevent frauds.
5. To discover errors and prevent them.
6. To facilitate statutory audit
7. To check the safety and proper accounting of assets.
8. Improvement in procedures.
9. To check commitment to Planning
10. To Review.

**Difference between Internal Check and Internal Audit**

1. **Nature of job-** Internal check is a system of recording transactions whereas internal audit is a system of checking the records.
2. **Time of examination –** The transactions are so recorded by internal check that the checking work continues with the recording. The checking of internal audit commences when recording or accounting work is over.
3. **Disclosure of fraud –** Internal check is a device wherein fraud is discovered in the course of the work. Internal audit discloses frauds when the work ends.
4. **Test of Effectiveness –** Internal check assures whether the accounting system is reliable and effective or not. Internal audit assures whether both the accounting system and internal check the reliable and effective or not.
5. **Operative function and Advisory function –** Internal check is an operative function whereas internal is an advisory function.
6. **Checking and Review-** The checking function continues with the accounting function in internal check system. But internal audit only reviews the accounting function.
7. **Persons involved –** In internal check, same persons are involved in both accounting and checking. But the persons acting as internal auditors are separate individuals. They have nothing to do with accounting function.

**Limitations of Internal Audit**

1. Limited ability
2. Lack of Independence
3. Use of Employees in Miscellaneous Jobs
4. Fraternity
5. Prejudices

**Internal check system in different business transaction**

The business transactions can be divided into following categories from internal-check point of view:

(i) Purchase of services, assets and goods.
(ii) Sale of goods.
(iii) Cash-Receipts.
(iv) Cash-Payments
(v) Internal transactions.

**Purchase of Service, Assets and Goods**

With regard to services, there is a Personnel Department in big companies which performs the job of purchasing the services. For purchase of services of high categories and permanent assets, the Board of Director or top management is generally authorised.

The function of purchase can be dividend into following segments:

1. **Estimation of requirements –** Usually it is the duty of the store-keeper to send indent to the purchase department for purchasing goods, by filling up Purchase Requisition Form, mentioning the quantity of goods, quality, code number and estimated cost while a copy of the Form is kept in the Stores. The Purchase Department can place orders for the supply of goods on the basis of these Requisition forms.

2. **Placing order for Supply of goods –** After making an estimate the Purchase Department begins the activity of purchasing goods. First of all, inquiries are made from different suppliers regarding goods and information is collected in respect of price, terms of purchases and other matters. After the decision of top officer with regard to the supplier order for goods are prepared. The purchase department maintains an order book for this purchase containing order forms which bear serial numbers.

3. **Receipt of Goods-** On the arrival of goods, it must be recorded in the Goods Inward Book, provided such a book is maintained at the gate, and thereafter, the goods must be sent to the Material Stores directly, together with 'packing note' sent by the vendor. The goods has got to be weighed, counted or measured. The Store-keeper must have no authority to receive until he has received a copy of the 'Order' for Goods.

4. **Checking the Invoice and making payment-** The Receipt clerk of the enterprise sends the invoice to the Purchase Department, where the stamp of number and date of receipt has got to be put on it.

**Purchases Returns and Internal Check**

As goods received are sometimes not in agreement with the order for goods or they get broken in transit, then it becomes imperative to return such goods. In this case, the internal check system shall take the following form:

1. **Intimation by Stores for Purchases Return-** If the goods received is not in accordance with the order, the Store- keeper must mention the fact in the remarks column of Goods Received Note. The intimation of goods to be returned must be sent by the Store-keeper to Purchase and Accounts Departments. It is also his duty to segregate such goods so that it may be returned soon after necessary action.

2. **Action by Purchase Department to Return Goods –** It is the Purchase Department which passes the invoice of in-coming goods. Obviously, the invoice has to be in agreement with goods Received Note sent by the Store-keeper. The Purchase Department is required to send an Advice Note annexed to the invoice, which must bear a clear advice that the purchase, return goods has got to be kept in mind, while passing the invoice.

3. **Action by Accounts Department-** The Accounts Department must check the said Advice-Note with the invoice and Goods-Received-Note received from Store-keeper. After a complete inquiry the Accounts Department must prepare a Debit Note and record it in the Purchase-Return Book.

4. **Return of Goods –** As soon as a Debit Note is received by the Purchase Department, action must be initiated to return the goods accordingly. The purchase Department must issue instructions to the Stores Clerk to pack the returnable goods and the same must be recorded in Goods Outward Book kept at the gate. The purchase Department, thereafter, must return the goods together with Packing note, Debit-note and other dispatch documents to the vendor and the Credit-note received from him must be sent to Accounts Departments, keeping back the particular with it.

### Credit Sales and Internal Check

1. **Receiving Sales order and preparing copies thereof –** Order for goods is received first of al by the Sales Department. As soon as an order is required, all the particulars thereof, should be recorded in the 'Order Received Book', i.e., the date of order, quantity of goods, name of customer, date of receipt etc.

2. **Dispatch of goods-** As soon as the Dispatch Section receives a copy of the order, the in-change officer of the section issues instructions for collecting, packing and dispatching goods and the copy is sent to Stores Section for necessary action.

3. **Dispatch of Invoice-** The Invoice clerk prepares invoice in accordance with the copy of the order received from Dispatch section, which is to be signed by a responsible officer after checking it. Invoice is prepared in three copies.

4. **Accounting of Sales and Receiving Payments-** The transaction is recorded in the Sales Book in accordance with the copy of invoice in Accounts Department. This accounting should never be in the hands of the employees of Sales Department or the cashier who keeps the accounts of payments received from the customers.

**Sales Returns and Internal Check**

1. Receipt of intimation as well as Sales-Return from Customer,
2. Preparation of Credit-Note and its dispatch,
3. Accounting on the basis of Credit-note.

**Cash Transactions and Internal Check**

1. **Cash Receipts –** The internal check system in respect of cash-receipts should be so effective that accounting is done as soon as cash is received and that the due amount is actually received. Cash-received can be of three types: (a) Cash receipts by mail, (b) On window, and (c) Cash Sales.
   - **(a) Cash receipts by mail –** A responsible employee must be authorised to open the mail containing Cash, cheque, Bills of exchange, and Draft etc. This work should never be assigned to the cashier. All such mails should be duly recorded in Mail-Receipt Register and then handed over to the cashier. All documents must be crossed and the word 'Not Negotiable' put in between the lines.
   - **(b) Cash-receipt on window-** The cash-receipt clerk must issue cash-receipt-foil duly singed by authorised person forthwith to the depositor and keep counterfoil with him. After business hours the cashier must hand over all the counterfoils and the total amount of cash received to the employee who has the charge of Cash-book. He shall cash entries and put serial number of receipt against each entry. Now, a third person shall post the entries in the ledger. The other things to be noted in this context are the same as detailed heretofore regarding Cash-receipts by mail.
   - **(c) Cash-Sales-** Cash-sales can be done by any of the following manners:
     - (i) Sales at the counter
     - (ii) Sales by Travelling agents
     - (iii) Postal sales.
2. **Cash Payments:**

   Frauds are common regarding payment for purchases of goods, sundry expenses, labour-charge etc.

Therefore, satisfactory evidence of each payment must be obtained. To make effective check on such payments, the system should be divided into the following divisions:

(i) Passing the payments for purchases

(ii) Preparing cheques for payment

(iii) Examining the cheques,

(iv) Accounting of the payments.

**Wages and Internal Check:**

The procedure of internal check for wages can be classified in four segments:

(i) Purchase of the services of labour ;

(ii) Accounting of each labourer on time and function basis;

(iii) Computing the wages of labour for a definite period;

(iv) Making payment of wages

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## UNIT III

## VOUCHING

Vouching is the examination of transactions of a business together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorized and are correctly recorded in books.

**Objects of Vouching -**

1. Authentication of accuracy and truth of book keeping entries.
2. Satisfaction of entries of business transactions.
3. Knowing the transactions unrelated with business.
4. Authentication of transactions.
5. Essence of auditing.

**The auditor must take care of following while vouching-**

1. Proper filing of vouchers in serial order.
2. Adoption of test check methodology for examining vouchers.
3. Comparison of evidences with accounting entries.
4. Voucher must be in name of the person or business whose account is audited.
5. It must be related with business transactions.
6. Voucher should relate to period under audit.
7. It must be in printed form.
8. The amount and calculations in voucher must be checked.
9. Voucher must be signed, authenticated and duly stamped.

**Vouching of Cash Book -**

Cash Receipts :

(i) Internal check should be examined.
(ii) Issue of receipts and use of receipt books should be checked.
(iii) System of depositing the receipts into bank should be checked.
(iv) Auditor must obtain the list of all memorandum books like cash diary, Kuchi Rokar Bahi, Pucci Rokar Bahi, etc.
(v) Vouchers must be serially numbered and the name, amount date in vouchers must tally with the accounting records.
(vi) Accounting records unsupported by vouchers must be probed.
(vii) Soiled, unissued or cancelled receipts should not be torn but checked along with counterfoils.

**Important points while vouching Cash Payments-**

1. Actuality of payment.
2. Payment relates to audit year.

3. Payment for business
4. Payment to right person
5. Right amount to be paid.
6. Payment must be due with regard to date.
7. Authorization of payment.
8. No payment for ultravires acts
9. Legitimacy of payment
10. Correct accounting

**Vouching Sales Book-**

1. On the basis of copies of sales invoices.
2. Help from other books like orders received book, goods outward book, correspondence, etc.
3. Intensive examination of goods sold of the end of the year and beginning of new year.
4. Recording of only actual sales.
5. Help from statements of accounts of debtors.
6. Audit of totals and postings of sales book.

**Vouching of Sales Returns Book-**

1. Vouching the records on the basis of copies of credit notes.
2. Checking of goods inward book and correspondence.
3. Examination of the records at the commencement of the next year.
4. Totals and ledger posting of sales returns to be carefully examined.

**Vouching Purchases-**

1. Examination of purchase book on the basis of invoices.
2. Record of lost vouchers.
3. Help from goods inward book, challan form and packing notes.
4. Checking of totals & postings on the basis of invoices goods inward books, purchase order, challan form, goods receipt notes.

**Vouching of Purchases Returns Book -**

1. Checking entries of purchases returns book on the basis of credit notes.
2. Tallying with goods outward book.
3. Checking the totals and postings in ledger.

**Vouching of Journal-**

1. Opening entries shall be vouched with the balance sheet of previous year.
2. Closing entries to be vouched by checking the ledger postings.
3. Rectification entries must be checked thoroughly and must be countersigned.

4. Adjustment entries relating to outstanding and prepaid expenses, unearned income and accrued income must be vouched on the basis of relevant documents.
5. Transfer entries must be backed by proper authority.
6. Bad debts must be vouched on the basis of authorization and relevant correspondence with the debtors.
7. Consignment transactions must be checked by the account sale received from the agent.

**Vouching Ledger Postings -**

1. Methodology of vouching, i.e., checking the ledger postings on the basis of entries in books of original entries.
2. Persons vouching the accounts.
3. Recording the errors.
4. Vouching the balances of accounts
5. Test checking of ledger postings.
6. Vouching of different ledgers – purchase ledger, sales ledger, etc.

**Vouching of various receipts -**

1. Cash Sales & Credit Sales : Voucher, date, serial no., account head, sales invoices, charging of sales tax and excise duty, copy of delivery order, sales order, rates, quantity and authorization by sales/ marketing manager.
2. Receipt from debtor : Cash/Bank receipt voucher, date, serial no., account head, copy of invoice, sales order, rates quantity party ledger, bank statement, sales register.
3. Other Income (Interest dividend, etc) : Bank receipt voucher, date, serial no., account head copy of dividend warrant, interest warrant. TDS certificate, rates paid up value, investment register, bank book, bank statement.
4. Loan received : Receipt voucher, date, serial no., account head, (secured/unsecured) loan agreement, hypothecation or pledge deed, rates of interest, principal amount, resolution of board of directors, bank statement, ledger.
5. Rent Received : Cash/Bank receipt voucher, date, serial no., account head, rent agreement, rent receipt, TDS certificate, prepaid or outstanding rent, bank statement, ledger.
6. Sale of Investment : Voucher, account head, broker's note, copy of demat account, rate, quantity, bank statement, investment ledger.
7. Bills Receivable Discounted : Voucher date, account head, discounting charges, copy of B/R, bank advice, noting charges, bank statement/book, BR register.
8. Sale of Fixed Assets : Receipts voucher, sale agreement, sale value and wdv, authorization by BOD, fixed assets register, bank statement.
9. Royalty Received : Receipt voucher, account head, copy of agreement, TDS certificate, rates and quantity explored, produced or sold, royalty register, ban statement.
10. Insurance Claim : Receipt voucher, account head, copy of intimation of claim copy of sanction, loss assessors report, verify the amount of claim, insurance claim register, bank statement.
11. Recovery of Bad Debts : Voucher, account head, debtors control account, commission to factor, bank book, statement or list of bad debts written off in previous years.
12. Miscellaneous receipts (subscriptions amount received from, agents etc) : Voucher, counter fails of receipts, bank pass book, membership register, statements of agents, etc.

**Vouching of Payments** :

1. **Purchase of Goods** : Payment voucher, purchase order, builty, material received note, inspection report, bank statement, rates, quantity and terms of purchases, stores ledger, goods inward register, authorization, cash purchase register.
2. **Payment to Creditors** : Receipt by customer, statement of account, invoice copy, discount and allowances, and other deeds.
3. **Salaries & Wages** : Payment voucher, attendance register, salary sheet, wage roll, time keeping record, bank statement, PF, ESIC, overtime sheets, cash book or bank book, ledger,
4. **Payment for Acquisition of Assets** : Payment voucher, account head, sale/purchase agreement, title deed, bank statement, transfer deed, valuer certificate, stamp duty, broker's statement, auctioneer's note, fixed asset register, cash/bank book, authorization by BOD, Articles of association, etc.
5. **Payment of Taxes (Income Tax, Sales Tax)** : Computation of tax, copy of challan of advance tax, TDS certificates, challan of self assessment tax, return, etc.
6. **Travelling Expenses** : Voucher tour program, schedule, TADA rules, expense voucher, receipts,etc.
7. **Preliminary Expenses** : Memorandum & Articles of association, registry, Cheque no., bills & receipts, rate of stamps, vouchers, etc.

## Verification of Assets & Liabilities

Verification is the process of substantiation involved in proving that a statement account or item is accurate and stated properly. It is an enquiry into the value, ownership & title, existence and possession, and presence of any charge on the assets as stated in the balance sheet.

**Objects of Verification -**

1. Picture of true position.
2. Correct valuation.
3. Not exceeding the actual.
4. Not less than actual.
5. Existence and possession.
6. Ownership and title.
7. Without fraud or irregularity.
8. Arithmetical correctness.
9. Correct presentation in the balance sheet.

**Position of Auditor as regards valuation of assets -**

An auditor is not a valuer or a technical expert. So he has to rely upon the valuation made by directors, partners, technical experts, surveyors, etc. However he must ensure that the valuation is fair and reasonable and based upon some accepted principles.

**Verification of fixed assets -**

(i) Goodwill -

(a) Existence : Whether purchased or acquired. Self generated goodwill is not said to be in existence.

(b) Records : Check the fixed asset register.

(c) Right of Ownership : Check purchase agreement, purchase consideration and MOU between the parties.

(d) Valuation and proper amortization as per AS-14, i.e. 5 years.

(e) Proper presentation and disclosure.

(ii) Freehold Properly :Which is in the name and title of owner.

(a) Ownership:Check the sale deed.
(b) Mortgage: Check the mortgage deed.
(c) Change in asset due to sale, purchase or construction work should be enquired and duly recorded.
(d) Revenue expenses regarding repairs and maintenance should be written off in P & L Account.
(e) The auditor must enquire into the existence, valuation and presentation in balance sheet.

(iii) Leasehold Property : It has two owners and both have qualified rights over it. The following points to be considered :

(a) Ownership : Lease deed should be examined.
(b) Mortgage : Relevant deed should be perused.
(c) Revenue expenses : To be charged to P & L.
(d) Existence, valuation and presentation B/S to be checked.

(iv) Plant & Machinery :

(a) Existence : Physical verification to be conducted, additions and deductions to be checked.
(b) Records : Check the fixed asset register.
(c) Ownership : Invoice receipt and purchase order to be checked.
(d) Revenue and capital expenditure should be properly accounted for.
(e) Proper presentation and disclosure under the schedule of fixed assets.

(v) Furniture, fixture and fittings :

The auditor has to verify the existence, records, changes ,ownership, valuation, presentation and disclosure in the balance sheet, along with depreciation.

(vi) Motor Vehicles :

The auditor has to verify the existence, fixed asset register, log books, invoices, registration book, incidental charges like insurance and road tax, depreciation, licences etc.

(vii) Copyrights, patents, trademarks, loose tools

Check the existence ownership, valuation, presentation in balance sheet, respective registers, write off etc.

(viii) Investments :

a) Ownership: name of client, pledge or lien of investments, Classification: trade or non trade, long term, short term, stock in trade.
b) Physical verification: obtain relevant certificates, etc.
c) Changes: broker's purchase note or sale note should be checked.
d) Valuation and disclosure :Current investments should be valued at lower of cost or fair market value. Long term investments should be valued at historical cost of acquisition.

(ix)Inventory :

a) Classification of inventory : Stores and spare parts, loose tools, raw materials, material in process, finished goods, waste or by products.
b) Existence and records in the stock register to be verified.
c) Right of ownership : Invoices, documentary evidence to be checked.
d) Valuation : According to AS-2, valuation is done on cost or NRV whichever is lower.Method is FIFO or weighted average and method is not changed, unless required.
e) Presentation and disclosure in Balance Sheet.

(x)Debtors, Loans and Advances:

a) List of debtors to be obtained.
b) Correspondence with debtors.
c) Inquiry into discount and bad debts, provision for bad debts.
d) Securities.
e) Presentation and disclosure in Balance Sheet.
f) Classification of debtors according to age, security and reliability, bad and doubtful.

Loans and Advances.:

a) Names & Amounts involved.
b) Terms and Conditions of loan.
c) Regularity of repayment.
d) Steps for recovery/repayment of overdues.

**Verification of Liabilities-**

Steps for verification

1. Examination of records .
2. Direct confirmation procedure.
3. Examination of disclosure.
4. Analytical review procedure.
5. Obtaining Management Representations.

The nature, timing and extent of substantive procedures to be performed is a matter of professional judgement of the auditor which is based on the auditor's evaluation of the effectiveness of the related internal controls.

**UNIT – IV**

**COMPANY AUDIT**

**Modes of Appointment of Auditors-**

**The First Auditor:**

a) The first auditor of a company shall be appointed by the board of directors within one month of the date of registration of the company. If the Board fails to appoint within the said period of one month, the company in general meeting may appoint the first auditors.
b) The first auditors shall hold office from the date of appointment to the conclusion of the first annual general meeting of the company.

**Appointment of Subsequent Auditors [Sections 224 (1), (IB) and (1C)]:**

At every annual general meeting, the auditor are appointed or reappointed by every company by passing an ordinary resolution. The appointment of auditors at an annual general meeting is an item of ordinary business. Such auditor holds office from the conclusion of the meeting in which they are appointed to the conclusion of the next annual general meeting.

**Appointment of Auditors by Central Government [Section 224(3)]:**

Where at any Annual General Meeting, no auditors are appointed or reappointed, in that case within 7 days of such a meeting, the company shall intimate this to the central government who may appoint a person to fill the vacancy.

**Compulsory Reappointment of Retiring Auditor (Section 224(2)]:**

At an annual general meeting, a retiring auditor by what so ever authority appointed, shall be reappointed except under any of the following situations:

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

**Appointment in case of Causal Vacancy [Sec. 224 (6)]:**

Where a vacancy is caused by the resignation of an auditor, the company in a general meeting shall only fill the vacancy. The Board of Directors may fill casual vacancy in the office of an auditor caused by any other reason than a resignation, while any such vacancies continues the remaining auditor or auditors, if any, may continue to act the auditor or auditors. Any auditor appointment in a casual vacancy shall hold office until the conclusion of the next annual general meeting.

**Appointment by special Resolution (Sec. 224 A):**

In case of a company in which not less than 25% of the subscribed share capital is held, whether singly or in any combination, by-

a. A public financial institution, or a government company or the Central Government or any state government, or
b. Any financial or other institution established by any provincial or State Act, in which a State Government holds not less than 51 % of the subscribed share capital, or
c. A nationalised bank or an insurance company carrying on general insurance business,

The appointment or reappointment at each annual general meeting of the company, an auditor or auditors shall be made by a special resolution.

It the company fails to pass such a special resolution for making the appointment of an auditor or auditors it shall be deemed that no auditor or auditors had been appointed by the company at its annual general meeting. In such a case, the Central Government may appoint a person to act as the auditor of the company.

**Appointment of Auditors of Government Companies (Sec. 619):**

Appointment of auditors in case of a government Company is subject to the provisions of Sec 619 which overrides Sec 224 to Sec 233 dealing with appointment, etc., of the auditors in the case of non-government companies. The auditor of a Government Company shall be appointed or reappointed by the Comptroller and Auditor General of India; however the appointment shall be subject to ceiling limits as per Sec 224 (1B).

**Removal of Auditor-**

**Different modes of removal:**

**(a) Removal of first auditors before expiry of term [Section 224(5)]:**
The company may remove the first auditor by passing an ordinary resolution at a general meeting (usually extra ordinary general meeting. No special notice is required for such removal under s. 225. However, procedure prescribed under section 225(2) and (3) shall be followed. Although Nomination notice is required to given to the members of the company at least 14 days before the date of the meeting by this way only any other person may be appointed in place of removed auditor.

(b) **Removal of subsequent auditor before expiry of their term:**
The company may, after obtaining the previous approval of the Central Government, remove the auditors before the expiry of their term by passing an ordinary resolution. No special notice is required for such removal. However, procedure prescribed under section 225(2) and (3) shall be observed.

(c) **Removal at an AGM of first or subsequent auditor:**
The company may, at an annual general meeting, provide expressly that a retiring auditor shall not be reappointed or appoint an auditor other than a retiring auditor. Special notice shall be required for such. The remaining procedure prescribed under section 225(2) and (3) shall be followed for his removal.

**Procedure prescribed under section 225(2) and (3) :**

(b) The notice for removal of an auditor shall be sent forthwith by the company to the auditor.
(c) After receiving notice auditor has the following rights :
(i) Right to be heard orally at the meeting.
(ii) Right to make a representation in writing to the company (not exceeding reasonable length).
(iii) Right to get his representation circulated among the members.
(d) Where a request is made by the auditor to circulate the representation, it shall be the duty of the company :
(i) to send a copy of the representation to every member of the company; and
(ii) to state the fact of the representation having been made in the notice given to the members.
(e) When representation is not sent by the company:
If a copy of the representation which was not sent as aforesaid because the representation was received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting by himself.

(f) Intervention by Central Government:
The copies of the representation need not be sent out and the representation need not be read out at the meeting if the Central government is satisfied that this right is being abused by the auditor to secure needless publicity for defamatory matter. The Central government may order the company's costs on such an application to be paid by the auditor, notwithstanding that he is not a party to the application. The application to the Central government may be made either by the company or by any other remember or director or other person.

**Rights of Auditors [Section 227]-**

1. Rights of Auditors to access books of accounts An auditors of a company shall have a right of access **at all times** to the books and accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.

2. **Right to obtain information and explanations [227(1)]:**

An auditor of the company is entitled to require from the officer of the company such information and explanation as he may think necessary for the performance of his duties as an auditor.

3. **Right to visit branch offices and access to branch account [Sec. 228(2)]:**

   Where the accounts of any branch office are audited by a person other than the company's auditor, the company's auditor is entitled to visit the branches, if he deems it necessary to do so for the performance of his duties as an auditor.

4. **Right to receive notice and attend general meeting [Sec. 231]:**

   The auditor has the right of

   - receiving all the notices and other communication relating to any general meeting of a company which any member of the company is entitled to have
   - He is entitled to attend any general meeting and
   - He is entitled to be heard at any general meeting which he attends on any part of the business which concern's him as an auditor.

5. **Right to make representation [Sec. 225]:**

   The retiring auditor is

- Entitled to receive a copy of the special notice intending to remove him or proposing to appoint any other person as auditor.
- Further, the retiring auditor sought to be removed has a right to make his representation in writing and request that the same be circulated amongst the members of the company.
- In case, the same could not be circulated, the auditor may require that the presentation shall be read out at the general meeting. The auditor also has the right to be heard at the general meeting.

6. **Remuneration of the Auditor [Section 224(8)]:**

   Auditor is entitled to receive remuneration as follows

   a. **Where appointed by the Board of Director**
   When an auditor is appointed by the Board of Directors, remuneration is also fixed by them.

   b. **Where appointed by shareholders:**
   In this case the remuneration is determined by the share holders at the AGM.

   c. **If appointed by the Central Government**
   In this case the remuneration is fixed by the Central Government.

   d. **If appointed by the Comptroller and Auditor General of India: the remuneration should be fixed by the co. in general meeting.**

7. **Right to correct any wrong statement**

8. **Right to have legal and technical advice.**

**Duties of Auditors:**

1. Duty as to enquiry [Sec. 227(1A)]:

Without prejudice to the rights given under s. 227 (1) auditor must enquire into following matters:

(a) Whether loans and advances made by the company on the basis of security:
(i) have been properly secured and

(ii) whether the terms on which they have been made are not prejudicial to the interest of the company or its members;

(b) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

(c) Whether the company is an investment company or a banking company, whether so many of the assets of the company as consists of shares, debentures and other securities have been sold at a price less than at which they were purchased by the company;

(d) Whether loans and advances, made by the company have been shown as deposits;

(e) Whether personal expenses have been charged to revenue account; and

(f) Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether the cash has actually been so received, whether the position as stated in the accounts books and the Balance Sheet is correct, regular and not misleading.

2. To report to members.
3. To specify a few things in the report.
4. Duties under section 227(4A).
5. To report for inclusion in prospectus.
6. To certify the Statutory Report.
7. Duties regarding Investigation.
8. To submit report on the Balance Sheet and P. & L. Account appended to the declaration of solvency at the time of voluntary winding up.

**Liabilities of an Auditor:**

**A. Civil Liabilities** **B. Criminal Liability**

**(A.) Civil Liabilities:**

1. **Liability for Negligence:**

If the auditor owes some duty towards the plaintiff (the person who files a suit in the court), and he does not discharge his duties with reasonable skill and care, resulting in a loss to the plaintiff, the auditor is guilty of negligence.

2. **Liability for Misfeasance:**

If the auditor does not approach and perform his duties it is misfeasance an auditor is liable to indemnity only if the following things are proved against him:

(iv) The auditor owned duty to the plaintiff:
(v) He failed to discharge his duty;
(vi) The plaintiff suffered loss due to non-performance of duty by the auditor.\

3. **Civil Liability under Indian Companies Act:**

**a. Under section 62:** If an auditor who can also be the auditor of the company gives untrue statement as expert in the prospectus issued by the company, he is liable to indemnify to each person who, believing the prospectus applied to purchase any shares or debentures and who has suffered loss due to the untrue statement.

**2. According to Section 543 of Indian Companies' Act:** The Court can compel an auditor to indemnify the company an amount deemed fit by the Court with regard to the being wound up, if he is held guilty of misfeasance and breach of trust.

**Civil Liability towards Third Party:**

1. **Not liable for negligence:** In regard to civil liabilities an auditor can be compelled to indemnify only if the auditor owed duty towards the plaintiff. Regarding company audit, as already stated, an auditor is appointed by company, therefore, he owes duty only to the company. If loss is suffered by third party due to negligence or misfeasance of the auditor, the auditor cannot be liable for it. It is only just because there is no contract between the auditor and third party.

2. **Liability for fraud:** An auditor is not liable to third party for negligence or misfeasance but if he is guilty of fraud, he shall be held liable to the third party also.

**B. Criminal Liability :**

**Criminal Liability under Companies' Act-**

1. Violation of section 57.

2. Not signing authenticating as per the Act.

3. For not rendering help to the Inspector.

4. Fraud in books. (Sec. 539)

5. Filing a suit for a criminal action.

6. For false statement in a report.

7. For untrue statement in the prospectus.

8. For prompting a person to invest.

9. For false evidence.

10. Arresting and producing the auditor in the court.

## Divisible Profits

Divisible Profit is that profit for the disbursement of which as dividend a company has legal right. Direct interest of shareholders of a company is in dividend, therefore, the management of the company always endeavours to disburse dividend to the shareholders but it cannot do so in such style as may result into the bankruptcy of the company, e.g. out of capital.

**Divisible Profits under the Indian Companies Act 1956:**

Section 205 lays down law on the following points :

(vii) Sources of Dividend [Section 205(1)]
(viii) Current Depreciation [Section 205 (2)]
(ix) Transfer to Reserves [Section 205 (2A)]
(x) Arrears of Deprecation [Section 205 (1)(a)]
(xi) Past Losses [Section 205(2)(b)]

It would be useful to elaborate the provisions:

(i) **Sources of Dividend:** As per Section 205(1), a company can disburse dividend for a certain year from the following sources:

(a) Profits of the year;

(b) Profits of the previous year;

(c) The two (a) and (b) together, that is, total thereof;

(d) Amount received for disbursement of dividend from the Central Government or any State Government for the payment of dividend in pursuance of a guarantee given by that government.

Dividend can be disbursed from the sources after making the following deductions from the profits of the company:

(a) Current Deprecation [Section 205(2)]

(b) Transfer to Reserves [Section 205(2A)]

(c) Arrears of Deprecation [Section 205(1)(a)]

(d) Past Losses [Section 205(b)]

The following points need consideration in respect of divisible profits :

(1) Section 205 of the Companies' Act must be abided by:

(2) The rules as provided in the Articles of Association must be kept in mind.

(3) The excess of income over the current expenditure may, after deducting depreciation on current assets, as required under sections 205 and 350 of the Companies Act, and creating adequate funds for payment of liabilities, be divided as dividend among the shareholders.

(4) The capital profit can be disbursed as dividend if (i) they have been realised in cash, (ii) there is surplus after writing off capital losses, and realised in cash, (ii) there is surplus after writing off capital losses, and (iii) the company is authorised to divide it as dividend by its Articles.

(5) It is compulsory to write off revenue losses before distribution of revenue profits as dividend and, similarly, it is also required to write off capital losses before disbursement of capital profit as dividend but it is not compulsory to write off capital losses before disbursement of revenue profits as dividend.

(6) It is not obligatory to write off the existing loss of paid up capital of the company or the past debit balance of P & L. Account (before deprecation) prior to distribution of dividend, if the company has adequate funds to discharge liabilities.

**Preliminaries before starting Audit-**

1. Appointment of Auditor.
2. Nature of Business of the Company.
3. Accounting Year.
4. Board of Director
5. Acquaintance with Management.
6. Knowledge of the byelaws regarding Memorandum of Association and Articles of Association.
7. Study of prospectus.
8. To receive the List of Books.
9. Obtaining the List of Employees and job description.
10. Knowledge of Internal Control.
11. Acquisition of Previous Final Accounts and Audit Report.

**Audit of Share-Issue-**

1. Checking the right to issue.
2. Checking the Procedure of issue.
3. Checking Books of original entry.
4. Checking Ledger Posting.
5. Presentation in Balance Sheet.
6. Audit of Calls in Advance.
7. Audit of Calls in Arrears.
8. Underwriting Commission and Brokerage.
9. Audit of Issues at premium
10. Audit of Issues at Discount.

**Audit of Share Transfer -**

1. Under the Companies' Act.
2. Under agreement:

    (i) Checking the Articles.

    (ii) Checking the Transfer Registrar.

    (iii) Checking the Transfer Deed.

    (iv) Checking the intimation to Transferee.

    (v) Action by Directors' Meeting

    (vi) Checking the Share Certificates.

    (vii) Checking the Register of Membership.

**Audit of Debentures -**

1. Checking the Articles
2. Looking into commission.
3. Compliance of Section 293.

4. Checking the restrictions on allotment.

5. Checking Debenture Register.

6. Checking of Transfers.

7. Checking the Charges.

8. Audit of Financial Books

(i) Cash Consideration

(ii) Other consideration

(iii) Commission and Discount

(iv) Application forms and Allotment

(v) Premium

(vi) Collateral security

(vii) Entries of interest

## Audit Report

**Reporting Requirements:**

The auditor of the company appointed u/s 224 of the Companies Act, 1956 is required to report u/s 227(2) & 227 (3) and 227(4A) which may be classified into two categories:

1. **Statement of opinion:**

**a) Opinion on true & fair view:**

Section 227(2): Whether in his opinion and to the best of his information and according to the explanations given to him,

- the accounts give the information required by the Act in t he prescribed manner and
- also given a true and fair view of the company's affairs in its balance sheet and correct picture of the profit or loss during the relevant financial year.

**b) Opinion on principal assertion:**

Section 227 (3) (b): Whether, in his opinion,

- proper books of accounts as required by law have been kept by the company so far as it appears from his examination of those books, and
- proper returns, adequate for the purposes of his audit have been received from branches not visited by him.

**2. Statement of facts:**

Report on principal assertions.

Section 227 (3) (a): Whether he has obtained all the information and explanations, which to the best of his knowledge and belief were necessary for the purpose of his audit.

Section 227(3) (bb): Whether the report on the account of any branch office audited under section 228 by a person other than the company's auditor, has been forwarded to him as required by section 228 (3) (c) and how he has dealt with the same in preparing the auditor report.

Section 227(3)(c): Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

Section 227(3)(d): Whether the profit and loss account and balance sheet comply with accounting standards referred to in section 211(3 c)

Section 227(3) (3): Auditor's report shall state his observations or comments, which have any adverse effect on functioning of the company in thick type or in italics.

Section 227(3) (f): Whether any directors are disqualified from being appointed as director under section 274(1) (g)

**Types of Audit Report:**

An audit-report can be of two types:

**1. Clean or Unqualified Report -**

If the auditor is fully satisfied on the facts to be incorporated in his report, he shall submit a clean or unqualified report on the Final Accounts. Such a report shall be given on the accounts regarding which the auditor does not find any irregularity or fallacy and about which there is no complaint and the auditor has no suspicion about their being true and fair. A report being clean means the auditor has performed the following acts:

(a) Adequate examination of books.

(b) Follow-up of generally accepted principles of auditing.

(c) Adoption of necessary procedures as demanded by particular circumstances.

(d) Use of reasonable skill and care.

**2. Qualified Report -**

If the auditor is not satisfied regarding the facts to be mentioned in his report, he must mention his dissatisfaction in his report. Such a report is called Qualified Report. By and large, the following reasons may be ascribed to a Qualified Report:

(a) The auditor could not adopt the necessary audit procedures in the examination of the accounts for want of necessary evidence in the form of vouchers of documents.

(b) The generally accepted principles of auditing have been violated.

(c) The auditor may not have received adequate information and explanations sought by him, e.g., the accounting system may be incomplete.

(d) There may be some inconsistency in the principles of accounting adopted by the company from year to year, e.g., the closing stock may not have been valued on the lines of last year and the change may not be acceptable to the auditor.

(e) Any other reason for which the auditor may be dissatisfied.

**UNIT-V**

**INVESTIGATION & SPECIAL AUDIT**

**INVESTIGATION**

It implies an enquiry into the accounts and records of a business undertaking. It is a sort of special audit with a particular object in view.

Investigation involves inquiry into facts behind the books and accounts, into the technical, financial and the economic position of the business or organisation.

Investigation is an examination of books and records preliminary of financing or for any specified purpose, sometimes differing in scope from the ordinary audit.

Investigation implies an examination of and record for some special purpose.

**Nature of Investigation**

Investigation is an enquiry into the financial statements of a number of past years with a view to know the real financial position or earning capacity. It is in fact a kind of special audit with predetermined scope depending upon the purpose to be achieved. Investigation is neither accounting nor auditing. Investigation is carried out not in substitution of audit, but in addition to audit. The investigating auditor may even have to investigate the audited accounts.

**Scope of investigation**

No general principle can be laid down with regard to the scope of every type of investigation. Scope of investigation, in each case, would be limited to the period or area to be covered by the investigator.

An investigation on behalf of a person intending to purchase running business of a sole trader will be restricted to the determination of value of assets, liabilities, reserves, existing potential and future prospects. An investigation to settle suspected irregularities in cash or stock would normally cover a period from three to six months.

**Objectives of Investigation**

The real objective of conducting an investigation by an auditor on behalf of his client is to provide him the desired information in the form of a report about the matter specified. Normally the objective of investigation is to collect, analyze and evaluate facts in respect of desired field of activity with a view on some special purpose as determined by the person on whose behalf the investigation is undertaken. In short investigation is to ascertain the financial position and earning capacity of a business on behalf of a certain person.

**The common objectives of investigation are listed below:**

1) Proposed purchase of business.

2) Proposed sale of business.

3) Reasons for low profitability.

4) Cause of high employee turn over.

5) Reliability of business data.

6) Proposed investment in particular securities.

7) Suspected fraud.

8) Joining in existing partnership business.

9) Borrowing funds.

10) Lending funds.

11) Proposed purchase of controlling shares in a company.

12) Suspected misfeasance against directors.

13) Detection of undisclosed income for tax purposes.

14) Suspected misappropriation by trustees.

**Process of Investigation**

1. Rceiving of Mandate of Investigation.
2. Planning of Investigation
3. Execution of Investigation
4. Summarizing and Report Making
5. Submitting the Report to the authority.

**Difference between Audit and Investigation:**

1. Legal binding

- Audit of annual financial statements is compulsory under the Companies Ordinance, 1984.
- Investigation is not compulsory under Companies Ordinance but voluntary depending upon necessity.

2. Object in view

- Audit is conducted to ascertain whether the financial statements show a true and fair view.
- Investigation is conducted with a particular object in view, viz to know financial position, earning capacity, prove fraud, invest capital, etc.

3. Period covered

- Audit is conducted on annual basis.
- Investigation may be conducted for several years at a time, say three years.

4. Parties for whom conducted

- Audit is conducted on behalf of shareholders (or proprietor, or partners).
- Investigation is usually conducted on behalf of outsiders like prospective buyers, investors, lenders, etc.

5. Documents

- Audit is not carried out of audited financial statements.
- Investigation may be conducted even though the accounts have been audited.

6. Extent of work

- Audit is normally conducted on test verification basis.
- Investigation is a through examination of books of accounts.

7. Report

- Audit report is addressed to shareholders (or proprietors or partners).
- Investigation report is addressed to the party on whose instruction investigation was conducted.

8. Adjustment in net profit

- In case of audit net profit disclosed by audited accounts is final without further adjustments.
- In case of investigation in order to determine real earnings certain adjustments are always essential.

9. Person performing work

- Audit is to be conducted by a chartered accountant.
- Investigation may be undertaken even by a non-chartered accountant.

**SPECIAL AUDIT**

**Special Audit of a Bank**

Auditor will begin his work by carrying out a thorough verification of the assets and liabilities of the banking company. Points to which he must pay his special attention in the performance of this work with regard to each individual asset and liability are discussed below:

1-Cash in hand / with other banks – Auditor will attend on the last date of the period under audit and will verify cash in hand or bullion by actual counting or weighing. He will compare and tally the balance with the Cash Book, the Day Book. Balances with the State Bank or other banks shall be verified.

2-Investments – Auditor shall obtain a list of the investments of the bank. He shall verify these investments at the close of the year by carrying out an actual inspection of the scripts or other documentary evidence available with the bank. He must take utmost care to see that the same investments are not shown to him twice.

3-Advances, Overdrafts, Loans and Cash Credits – Auditor shall obtain a schedule of all loans, advances, cash credits and overdrafts etc from the bank and will then proceed to verify them with the balances of respective leaders. The totals will be compared and checked up with the respective total accounts maintained in the general ledger.

The responsibilities of the auditor with regard to the verification of loans and advances etc are very heavy. He will have to pay special attention with regard to the different kinds of advances such as:

a) Advances against government securities;

b) Advances against stock in trade;

c) Advances against properties;

d) Advances against Life policies;

e) Advances against fixed deposits;

f) Advances against bullion.

4-Bills Discounted and Purchased – Auditor will verify bills discounted and purchased as recorded in the books with those which are in the actual possession of the bank. He shall see that the limits fixed by the Board of Directors have not been exceeded and that the total of the Bills Discounted Ledger agrees with the balance of the control account in the General Ledger. He will examine the date of maturity of each bill in order to verify the amount of overdue bills.

5-Contra Accounts – Usually they relate to the following types of accounts (a) Bills for collection (b) acceptances, guarantees, letters of credit etc, opened on behalf of the customers. These items appear on both sides of the balance sheet as they constitute both the assets and liabilities of the bank.

6-Branch adjustments – This item discloses the combined effect of the difference sin the inter-branch balances. Auditor shall verify this item from the certificates of balances received from branches preparing reconciliation statements.

7- Other Assets – Other assets of the bank shall include premises, furniture and fixtures, stock of stationary, interest accrued on investments etc. Auditor shall examine the title deeds or any other type of documentary evidence in order to ascertain that the assets of the bank, on the date of the Balance Sheet, do exist in the name of the bank and that they have been properly valued.

8-Liabilities – Important items which usually appear on the liabilities side of the Balance Sheet of a bank are the customer's deposits, borrowings from other banks or agents etc, bills payable, branch adjustments, liabilities for outstanding expenses and contingent liabilities etc. Auditor will try to check up the understatement or overstatement of liabilities.

**Audit of Educational Institutions**

Audit of books of educational institutions like school, college, universities etc. or other such institutions which are engaged in the educational field is known as audit of educational institutions. Auditor should check income and expenditure account and balance sheet of such institutes in order to verify and report the true and fairness of results presented by income statements and financial position presented by the balance sheet. Generally, the methods and procedures for vouching and auditing is same even though an auditor of educational institution should perform following tasks:

1. The auditor should go through the University Act. Trust deeds and should note the rules and regulations relating to accounts. The governing body may pass resolutions from time to time in respect to accounts. A copy of minutes books should be made available to him so that he may be able to confirm whether the decision of the government body have been compiled with.
2. Auditor should obtain a copy of budget or financial statements to study of different heads of income and expenditure.
3. Auditor should thoroughly assess the strength of internal check.
4. Auditor should vouch the grant-in-aid from the government carefully.
5. Auditor should verify the receipts of monthly fees from students, from counterfoils or carbon copy of the receipts. He should also see whether cash received has been banked daily or not.
6. Other charges from the students such as examination fees, laboratory fees, fines etc. should be carefully verified.
7. Any fees received in advance should be properly adjusted.
8. The concession of fees and other charges should be duly authorised by the proper authority. Any charges becoming irrecoverable should be written off only after proper authority has recommended.
9. Any grant-in-aid or funds received for a particular purpose must be utilised for the same.
10. The donations and other subscriptions from the various authorities have been accounted for and acknowledged.
11. The income from property, investment etc., should be properly verified from the vouchers.
12. Auditor should vouch the amount of salaries paid with the Salary Register. Any increment given to an employee shall be duly sanctioned.
13. The staff provident fund should be verified and it should be seen that it is invested as per the rules.

14. The establishment expenses must be carefully vouched and it should be seen that capital expenditure has not been treated as revenue expenditure or vice versa.
15. The payment of scholarship should be verified with the receipt from students and Scholarship Register.
16. All the assets and liabilities should be properly exhibited in the balance sheet.
17. The stock of equipment, stationary, furniture should be carefully verified.
18. While making payment of staff salaries, income tax should be deducted at source and shall be duly deposited with the Income Tax Department.

**Audit of Non –Profit Institution:**

1. Examine the constituion, rules and regulations or the Trust Deed if any.
2. Examine that the fund for specific purpose have been used accordingly.
3. Vouch the donations and Receipts
4. Vouch the Income from Investments.
5. Vouch the Receipt of Rents
6. Vouch the payment with the minute book of the trustees or the managing committee regarding important payments.
7. Verify the purchase of Investments
8. Verify the cash and bank balance.
9. See the accounts are drwn up according to the regulations.
10. If any special Act has been passed by the State relating to the Charitable Institutions, see that the form of accounts and auditors report are drawn up according to the regulation.

**Audit of Insurance Companies:**
1. Vouch the premiums received with the copies of insurance policies, cover notes or premium receipts.
2. Interest and dividends are to be checked.
3. The Cliams paid or payable by the company to be checked.
4. Commission payments should be vouched.
5. Management Expenses should be examined.
6. All the reinsurance in detal should be checked.
7. All the investments made and cash baalnced should be verified.
8. Srutinise carefully the outstanding branch and agency balances to determine that they are recoverable.
9. See that the sufficient amount has been set aside as reserve for unexpired risks.
10. Make sure that all the contingent liabilities are ascertained and provided for.
11. Make sure that the code of conduct have been duly observed as it is required to be observed by the insurance companies in India.
12. See that the annual account of insurer have been prepared in accordance with the prescribed forms and regulations.

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