GCM (S4) 03

Exam Code : AUD

AUDITING

SEMESTER - IV

COMMERCE

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

Subject Experts

Professor H.C. Gautam, Department of Commerce, Gauhati University

Professor Nayan Barua, Department of Commerce, Gauhati University

Dr. S. K. Mahapatra, Department of Commerce, Gauhati University

Course Coordinators : Dr. Devajeet Goswami, Dr. Dipankar Malakar and Mr. Sanjib Ghimire, Department of Commerce, K.K.H.S.O.U.

SLM Preparation Team

UNITS	CONTRIBUTORS
1 & 2	Dr. G.G. Banik, Gauhati Commerce College
3 & 12	Sangeeta Deka, Junior Finance Officer, IIIT, Guwahati
4	Dr. Devajeet Goswami, KKHSOU
5	Dr. Jugal Kishore Barman, Gauhati Commerce College
6	Dr. Dhani Kanta Kalita, K. C. Das Commerce College
7 & 10	Dr. Ramen Barman, Gauhati Commerce College
8,13,14 & 15	Sanjib Ghimire, KKHSOU
9 & 11	Dr. Safiqul Haque, K. C. Das Commerce College

Editorial Team

Content : Professor H.C. Gautam, Dept. of Commerce, G.U.

Structure, Format & Graphics : Mr. Sanjib Ghimire, Department of Commerce, KKHSOU

First Edition : December, 2018

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Printed and published by Registrar on behalf of the Krishna Kanta Handiqui State Open University.

Headquarter-Patgaon, Rani Gate, Guwahati-781017
City Centre-Housefed Complex, Dispur, Guwahati-781 006; Web: www.kkhsou.in

The university acknowledges with thanks the financial support provided by the **Distance Education Bureau, UGC** for the preparation of this study material.

COURSE INTRODUCTION

This course will focus on the auditing aspect. It is mainly concerned with checking the accounting entries so that the financial statements of the organization show true and fair view of its financial position. First unit of this course will help you in gaining knowledge about the meaning and objectives of auditing. We will also discuss the classes of errors and frauds and duty of the auditor in relation to the errors and frauds. In unit 2 we will discuss the various types of audit. In Unit 3 we will discuss about certain special areas of Audit. Unit 4 will be helpful for you as you will come to know the preparatory steps that an auditor must take before appointment and commencement of audit work. Unit 5 is about test checking and internal check. As there are large number of entries, the auditor can rely on the internal check system and can adopt test check. But he remains liable for any mistakes on his part. In unit 6 we will discuss vouching. Vouching helps in ascertaining the accuracy and authenticity of the entries. In unit 7 and 8 we will discuss the verification of assets and liabilities, differences between vouching and verification etc. Unit 9 will be focusing on investigation matters. In unit 10, we will discuss about company auditor. This unit will cover the various aspects like, qualification, appointment, rights, duties etc. of a company auditor. Unit 11 will cover the points to be considered for audit of accounts of Non-Profit Companies, Educational Institutions, Club, Hotel and Hospital. In Unit 12 we will discuss the important points in audit of Depreciation. Unit 13 is concerned with auditing of reserves created in the Books of Accounts. In Unit 14, we will discuss about the Auditor's Report. And in Unit 15, we will disuss about the recent trends in Auditing.

While going through a unit, you will notice some along-side boxes, which have been included to help you know some of the difficult, unseen terms. Some "ACTIVITY' (s) have been included to help you apply your own thoughts. Again, we have included some relevant concepts in "LET US KNOW" along with the text. And, at the end of each section, you will get "CHECK YOUR PROGRESS" questions. These have been designed to self-check your progress of study. It will be better if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with "ANSWERS TO CHECK YOUR PPROGRESS" given at the end of each unit.

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UNIT 1: INTRODUCTION TO AUDITING

UNIT STRUCTURE

1.1 Learning Objectives
1.2 Introduction
1.3 Origin of Auditing
1.4 Meaning and Objectives of Auditing
1.5 Advantages of an Audit
1.6 Qualities of an Auditor
1.7 Classes of Errors and Frauds
1.8 Auditor's Duty Regarding Errors and Frauds
1.9 Let Us Sum Up
1.10 Further Readings
1.11 Answers To Check Your Progress
1.12 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the origin of auditing
- explain the meaning and objectives of auditing
- discuss the advantages of auditing
- describe the qualities of an auditor
- explain the different classes of errors and frauds and the auditor's duty regarding such errors and frauds.

1.2 INTRODUCTION

Auditing is basically concerned with the checking of the financial statements so as to find whether such statements represent a true and fair view. The practice of auditing grew from the necessity of enforcing a system of check upon persons who are entrusted with the purpose of recording of receipts and disbursement of money on behalf of others. In this unit we will first discuss the origin of auditing and the different objectives of auditing. Then we will discuss the various advantages of auditing and the necessary

qualities of the auditor. This unit will also focus on the different types of errors and frauds that may be present in the financial statement.

1.3 ORIGIN OF AUDITING

Auditing as it exists today can be associated with the introduction of large- scale production as a result of industrial revolution during the 18th century. This revolution led to a great increase in the volume of trading operation which also required huge amount of capital investment. Individual business houses were not in a position to provide the necessary finance because of their limited financial and credit resources. Auditing in its simple form originated almost simultaneously with the development of organised systems of Accounting. Mesopotamian relics of commercial transactions pertaining to the period 3400-3200 B.C. reveal tiny marks, dots, ticks and circles at the side of the figures, indicating that those figures had been checked. The ancient Egyptians got there fiscal receipts recorded separately by two officials while another official conducted their audit. The Greeks appointed checking clerks to scrutinise the accounts of public officials at the expiry of their term of office. The Romans had distinguished between the persons authorising expenditure and the person responsible for actual receipts and payments. They also instituted an elaborate system of checks and counterchecks within the financial administration.

In Valmiki's Ramayana, Rama asked Bharata when the latter met him in the forest: "*Is your income more than your expenditure and your expenditure less than your income.*"

In the *Mahabharata*, king Yudhisthira ordered his brother Nakul to look after the army's accounts.

Further the discovery of steam power, development in the means of transport and communication, expansion of banking facilities and mechanical invention also made it inevitable for businessman to adopt some other forms of business organisation and management. This led to the formation of numerous joint stock companies and other corporate bodies. The introduction of joint stock companies, where there is a clear distinction between ownership and management, recognised the inevitability of auditing to the greatest extent.

In early stages of civilisation, people's needs were few and the business transactions were limited in number. The size of the business unit was small and it was mostly owned and managed by the owner himself. Business transaction was recorded in crude form of accounting and they were mostly recorded by the owner himself. Hence, the necessity of checking accounts was rare and the practice of auditing did not develop much.



Actuating — Causing motion or action or change

When the ancient states and empires became stabilised it was felt necessary that a system of checking should be enforced upon public accounts. Ancient Egyptians, the Greeks and the Romans used to get their public accounts audited. As early as 2000 years, the Babylonian law provided for the taking of accounts between the principal and the agents. Greeks and Romans had well developed system of accounting and the Roman bankers kept separate accounts for each customer with one page of debits and the other page for credits. Even in Great Britain, earliest accounts were maintained in narrative form. In ancient India, accounting and auditing were also used in some forms. During Chandra Gupta Maurya, public accounts were subject to audit. During that period, Chanakya in his famous Artha Sastra had mentioned about accounting and auditing of state finance.

During this period, the king was the custodian of public finance but the accounts were maintained by his officials. So in order to ensure the authenticity and correctness of accounts some sort of checking of the public accounts became necessary. Hence the practice of auditing developed to a certain extent during that period.

1.4 MEANING AND OBJECTIVES OF AUDITING

The word audit is derived from the Latin word '*AUDIRE*' which means to hear and from '*AUDIRE*', the word 'AUDITOR' has been derived which otherwise means the hearer. The accounting parties were required to attend before the auditor who heard their accounts. The parties are required to explain their accounts orally. Thus, the duty of the auditor in the early period was to make an examination of accountants in person. In olden times, the methods of accounting were so crude and the numbers of transactions were so small that every individual was in a position to check all the

transactions recorded by himself or his employees. Whenever the owner of the business suspected frauds or misappropriation of funds, he appointed an official to check the accounts. Such a person would meet the concerned employees and hear whatever they had to say in connection with the accounts. This person came to be known as 'auditor' i.e. 'hearer.'

The term audit has been defined by different authors and experts in different ways.

According to *Montgomery,* **"**Auditing is a systematic examination of books and records of a business or other organisation in order to ascertain or verify and to report upon the facts regarding its financial operation and the results thereof.**"**

According to *Spicer and Pegler,* **"**An audit may be an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy that the balance sheet is properly drawn up, so as to give a true and fair view of the state of the affairs of the business, and whether the Profit and Loss Account gives a true and fair view of profit or loss for the financial period according to the best of his information and the explanations given to him as shown by the books; and if not, in what respect he is not satisfied.**"**

Objectives of Audit

The concept of audit is correlated with the concept of accounting. Accounting is concerned with three aspects-

Constructive Aspect

This aspect deals with the formulation of basic and fundamental accounting theory.

Recording Aspect

This deals with the recording of business transaction in accordance with the basic accounting theory.

Control Aspect

This deals with checking, verification and confirmation of accounts.

The objectives of the audit include the verification of books of accounts and financial statements as its principal objective in addition to its traditional objectives of detection and prevention of errors and frauds.

The objectives may be classified mainly into two groups—

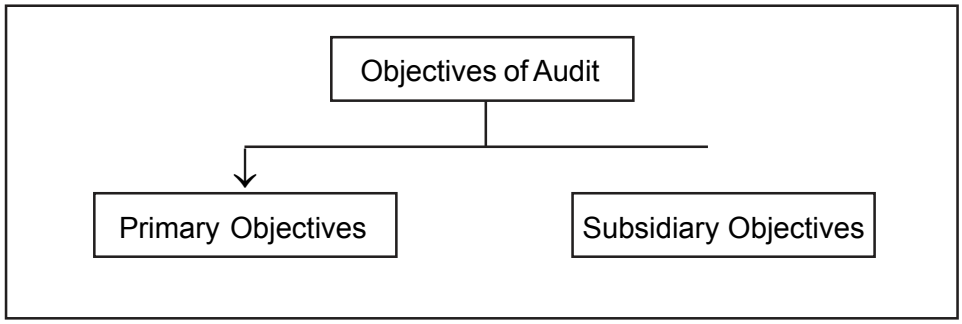
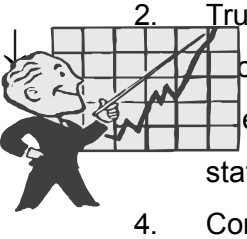


Figure: Objectives of Audit

PRIMARY OBJECTIVES

The primary objective of an audit is to enable the auditor to make opinion on:

1. Truth and fairness of the financial position as shown by the balance sheet.
2. Truth and fairness of the trading results or the results of operation as own by the profit and loss accounts.



equacy of information required to be disclosed in the financial statements.

4. Compliance with statutory requirements.
5. Accuracy and reliability of books of accounts and underlying records from which financial statements have been prepared.

SUBSIDIARY OBJECTIVES

(i) Detection and Prevention of errors and

(ii) Detection and Prevention of frauds.

CHECK YOUR PROGRESS

Q 1: State three primary objectives of auditing

i) .....

ii) .....

iii) .....

1.5 ADVANTAGES OF AN AUDIT

In this section we will discuss the advantages of audit. Following are the advantages of audit:

To the Business in General

- **Auditing ensures Correctness of Accounts:**
  As the auditor examines and verifies the accounts, the audited accounts and statements are considered as correct.
- **Auditing helps in Detection and Prevention of Frauds and Errors:**
  Frauds and errors are detected during this course of examination of accounts and thereby it exercises a moral check upon the employees.
- **Auditing Makes the Staff Vigilant and Alert:**
  Regular audit makes the staff alert and vigilant and compels them to make the accounts up to date.
- **Auditing Increases Reliability of Accounts:**
  As accounts are audited by an independent auditor, audited accounts are more reliable to bankers and outside creditors and thus loans can be obtained on the basis of audited accounts.
- **Auditing Makes Settlement of Claims and Disputes Easier:**
  Insurance claims can be settled on the basis of audited accounts as audited accounts are acceptable to the insurance companies.
- **Auditing Helps in the Valuation of Property and Goodwill:**
  In case of sale of a business the value of the business and goodwill can be ascertained from the audited accounts.
- **Auditing Helps in the Settlement of Taxes:**
  Audited accounts are accepted by various tax authorities as a basis for settlement of taxes.
- **Auditing Enables Comparison Of Accounts Of Different Periods:**
  If the accounts are maintained on uniform basis and are audited by an independent auditor, such accounts can be compared from year to year and correct measures can be taken.

- **Auditing Enables The Business To Get Suggestions For Improvement:**

  As the auditor is a technically sound person, the management can seek advice for the improvement in the system of accounting and internal control and other technical points relating to accounts.

To the sole trader

- **Auditing Ensures Proper Maintenance of Accounts:**

  An individual is assured that his accounts are properly maintained and such accounts are free from frauds and errors when accounts are audited by an independent auditor.

- **Auditing Provides Basis For Estate Duty:**

  Audited accounts provide a basis to the executors and administrator for the preparation of estate duty accounts.

- **Auditing Provides Basis For Wealth Tax:**

  Audited accounts also provide a basis for assessment of wealth tax.

- **Auditing Provides a Check on the Accounts Prepared by Agents:**

  When agents are appointed, audit of the accounts prepared by them provides a check against the commission of errors and frauds.

- **Auditing Provides a Basis For Action in Bankruptcy:**

  Audited accounts serve a basis to determine action in bankruptcy and insolvency.

- **Auditing Provides a Basis For Income Tax, Sales Tax and Settlement of Claims:**

  Audited accounts are accepted as basis for purpose of assessment of taxes and settlement of claims with insurance company.

- **Auditing Increases Efficiency in the Maintenance of Accounts:**

  Audit of accounts improves the efficiency of the accounting staff.

To partnership business

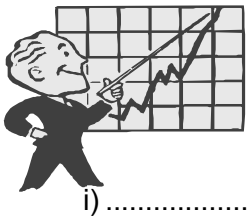
- **Auditing helps in avoiding disputes and mistrusts among the partners:**

  When partnership accounts are audited by an independent auditor, the partners accept the authenticity of the accounts and as such, causes of mistrusts and disputes are eliminated.

- **Auditing makes the accounts acceptable to sleeping partners:**
  When all the partners do not participate in the business, the non participating partners accept the audited accounts as authentic.
- **Auditing provides a basis for valuation of goodwill and other assets:**
  In case of admission, retirement, death, change in profit sharing ratio etc, goodwill and other assets can be valued on the basis of audited accounts.
- **Auditing helps in settling accounts in case of retirement and death:**
  Interest of the retiring or deceased partners can be settled on the basis of audited accounts.
- **Auditing ensures compliance with the provision of Partnership Act or Deed:**
  When the accounts are audited, it implies that provisions of the Partnership Act or deed have been duly complied with.
- **Auditing provides an opportunity for getting expert advice in filling tax returns:**
  Auditor helps in the preparation and filling of income tax returns.

To a joint stock company

- **Auditing ensures the protection of the shareholders' interest:**
  As the shareholders have no direct access to the books of accounts of the company, they are assured by the faithful work of the auditors that they are not defrauded by unscrupulous direction and their interest is thus protected.
- **Auditing Provides a control device:**
  It acts as a check against commission of fraud by employees and the management.
- **Auditing Stops erosion of capital:**
  When the accounts of a company are audited, shareholders are assured that the net profit as shown by the profit and loss account is true and any dividend is paid only out of real profit. Thus, the capital of the company remains intact.



CHECK YOUR PROGRESS

Q 2: State two advantages of auditing to the business in general.

i) .....

ii) .....

1.6 QUALITIES OF AN AUDITOR

An auditor is a professional person who offers to render services to his clients. The clients expect from his knowledge of professional techniques and some personal qualities which may be necessary in the application of professional skills in a particular situation. These qualities may be classified as-

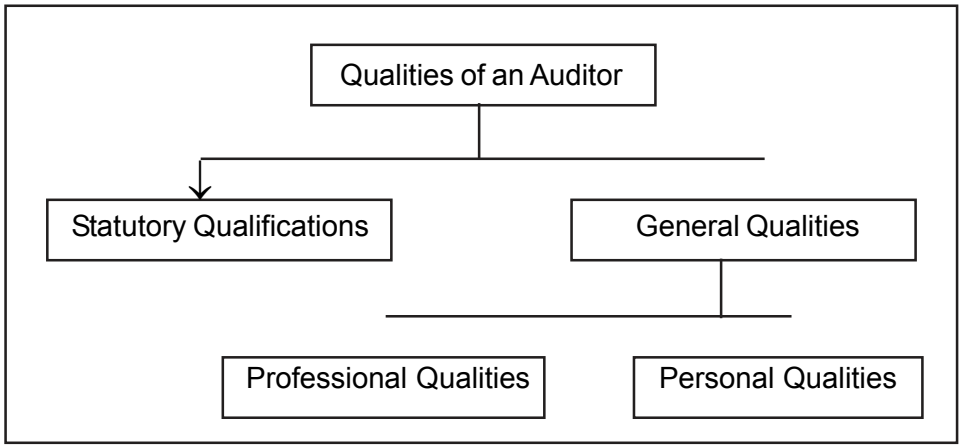


Figure: Qualities of an Auditor

Statutory Qualifications

According to Section 141 of the Companies Act, 2013, a person shall be qualified for appointment as an auditor of a company if he is a chartered accountant within the meaning of the Chartered Accountants' Act and is a holder of a certificate of practice from the Institute and such certificate is not subsequently cancelled thereafter.

General Qualities

An auditor is required to possess certain other qualities. Some of these qualities are acquired by an auditor while inherent qualities are known as personal qualities.

Professional Qualities

- **KNOWLEDGE IN ACCOUNTANCY**

  An auditor must possess a sound knowledge of theory and practice of accountancy so that he may be able to apply them in verification and interpretation of accounts.

- **KNOWLEDGE ABOUT THE ORGNISATIONAL SET UP**

  An auditor is required to possess a considerable knowledge about the organisational and operational methods of various types of concerns.

- **THOROUGH KNOWLEDGE OF TECHNIQUES OF AUDITING**

  An auditor must be the master of the different auditing techniques and must know how to apply the standard auditing practices in a particular situation.

- **KNOWLEDGE OF MERCHANTILE LAWS AND ECONOMIC PRINCIPLES**

  An auditor must be familiar with the principles and practices of various business laws that affect his profession, such as, Company Laws, Mercantile Laws, and Taxation Laws etc

- **GRASP OVER THE TECHNICAL DETAILS OF A BUSINESS**

  An auditor should be able to grasp quickly the technical details of the business whose account he is auditing.

- **ABILITY TO WRITE THE REPORT ON THE AUDITED ACCOUNTS CLEARLY, CORRECTLY, CONCISELY AND FORCEFULLY**

  An auditor should be able to write the report on the audited accounts clearly, correctly, concisely and forcefully.

- **KNOWLEDGE ABOUT AUDIT CASE LAWS AND IMPORTANT LEGAL DECISIONS**

  An auditor must have the knowledge of audit case laws and important decisions which have bearings on his powers and duties.

- **ACQUAINTANCE WITH THE LATEST CHANGES AND DEVELOPMENTS**

  Audit standards are continuously changing with the growth in the size of the business units. So he must have the knowledge of the latest changes and developments in audit practices.

Personal Qualities

- **HONESTY AND INTEGRETY**

  An auditor must be honest, straight forward and sincere in his approach to his professional work. The need of integrity of the auditor arises from the very nature of the function that he performs. He must not certify what he does not believe to be true, and he must take care before he believes what he certifies as true.

- **NEUTRALITY**

  He must be impartial and must not be influenced by any party in the discharge of his duties. It is important that the auditor should not only to subordinate his judgement to that of others, but he should also be free of any such interest as might affect his independent judgement even sub-consciously.

- **OPEN MINDED**

  An auditor should have an open mind and should not adopt an attitude of suspicion.

- **COMMUNICATION ABILITIES**

  An auditor may have carried out the auditing procedures with utmost competence. But the usefulness of his work will be limited if he cannot report the results of his efforts in a clear manner. Hence, proficiency in written and oral communication is of great importance to an auditor.

- **INTELLIGENCE AND TACTFULNESS**

  An auditor should be intelligent, tactful and methodical in his work so that he can extract necessary information on a fact without impairing the sentiments of the employees.

- **PATIENT**

  He must be patient and reasonable and be prepared to hear the arguments of the employees and management.

- **CONFIDENTIALITY**

  He should maintain confidentiality and should not leak out the secrets of the business.

CHECK YOUR PROGRESS

Q 3: State two professional qualification of an auditor.

i) .....

ii) .....

1.7 CLASSES OF ERRORS AND FRAUDS

The errors may be of the following types:

- **Errors of Omission:** When a transaction is completely or partially omitted from the books of accounts, it is known as an error of omission. This type of error is very difficult to detect, because these are not reflected in the Trial Balance. For example, (i) Sales have been omitted from sales book, (ii) Rent paid but not recorded in the books.
- **Errors of Commission:** When entries are wrongly recorded in the books, such errors are known as errors of commission. Such errors may or may not affect the agreement of Trial Balance. For example, (i) Goods purchased for Rs. 5,000/- but recorded in the books as Rs.500/-. This error will not affect the Trial Balance. (ii) Rent paid Rs. 3,000/- and recorded in Cash Book correctly but the same is posted in the Rent account as Rs. 300. This error will affect the agreement of Trial Balance.
- **Compensating Errors:** When the effect of one error is offset by another error, it is known as Compensating Error. Such errors do not affect the agreement of the Trial Balance, and as such, cannot be easily located. For example, (i) Sales Book is undercast by Rs. 3,000/- and Purchases Book is also undercast by the same amount. The Trial Balance remains unaffected. (ii) Salary account is undercast by Rs.6,000/- and Advertisement account is overcast by the same amount. The Trial Balance remains unaffected.
- **Errors of Principles:** When principles of recording the transactions are not followed, the error is known as error of principles. For example, (i) Salary paid to Ram is wrongly debited to Ram account. (ii) Rent paid for Building is wrongly debited to Building account.

- **Duplicating Errors:** When the same transaction is wrongly recorded twice, it is known as duplicating error.

Fraud

Fraud means convincing a person to believe a particular fact to be true which, in fact, is not true. It means false representation of facts made intentionally or without belief in its truth with a view to defraud somebody. The Frauds may be of the following types:

- **Misappropriation of Cash:** It is also known as embezzlement or defalcation of cash. It is possible irrespective of the size of the business— whether small or big. Since the proprietor has direct control over the receipts and payments of cash in the small businesses, the chances of embezzlement of cash are small in small businesses. But in large businesses, such chances are greater. There are different methods of Misappropriation of Cash; among them, the most frequent one is *Teeming and Lading* as followed by the employees in charge of cash.
- **Misappropriation of Goods:** It is very often noticed that the valuable goods of the organisation are stolen by dishonest employees or workers of the organisation. This is known as misappropriation of goods. Generally, goods of small size but of high value are misappropriated. Such types of frauds are very difficult to detect.
- **Manipulation of Accounts:** These are fraudulent manipulations through falsification of accounts. These are generally committed through passing of false entries with the motive of misappropriating funds slowly and steadily. Such types of frauds are generally committed by highly ranked personnel of the organisation.

1.8 AUDITOR'S DUTY REGARDING ERRORS AND FRAUDS

Detection of errors and frauds is the secondary object of an audit. But it is still an important duty on the part of an auditor in the sense that the existence of errors and frauds may involve the accuracy of the accounts and financial statements which the auditor is required to certify.

Nowadays the duty of safeguarding the assets of the company rest on the management and not on the auditor. The management safeguards the assets through sound internal control like internal check and internal audit. The audit is to conduct a routine checking and vouching where there is a sound internal check system.



1.9 LET US SUM UP

In this unit we have discussed the following-

- Auditing as a profession has grown up during industrial revolution.
- Auditing is the systematic examination of books of accounts.
- The primary objectives of auditing are to ascertain the truthfulness and fairness of profit and loss account and balance sheet.
- The subsidiary objectives of auditing are to detect and prevent frauds and errors.
- The advantages of audit to the business, sole trader, partnership business and the joint stock company.
- The qualities of an auditor- statutory qualification, professional and personal qualities.
- Different types of errors like, errors of omission, errors of commission compensating errors etc.
- The types of frauds like, misappropriation of cash, misappropriation goods and manipulation of accounts.
- Auditor's duty regarding these errors and frauds.



1.10 FURTHER READINGS

1) Basu, S. K. (2008), *Auditing : Principles and techniques*, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), *Contemporary Auditing*. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). *Principles and practice of Auditing*, New Delhi, Himalaya Publishing House.



1.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) to ascertain the truthfulness and fairness of balance sheet.

ii) to ascertain the truthfulness and fairness of profit and loss account.

iii) to ascertain the adequacy of information disclosed by the financial statements.

Ans to Q No 2: i) Auditing ensures correctness of accounts.

ii) Auditing helps in the valuation of property and goodwill.

Ans to Q No 3: i) Knowledge in accountancy.

ii) Thorough knowledge of techniques of auditing.



1.12 MODEL QUESTIONS

Q 1: Discuss the objectives of auditing.

Q 2: Explain the advantages of audit to partnership firm.

Q 3: Discuss the statutory and professional qualifications of auditor

Q 4: Discuss the different types of errors

Q 5: Discuss the different types of frauds.

*** ***** ***

UNIT 2: CLASSIFICATION OF AUDIT

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Classification of Audit on the basis of Organisational Structure

2.4 Classification of Audit on the basis of Conduct

2.5 Let Us Sum Up

2.6 Further Readings

2.7 Answers to Check Your Progress

2.8 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the classification of audit on the basis of organisational structure
- discuss the classification of audit on the basis of conduct.

2.2 INTRODUCTION

You are aware that auditing is the examination of books of accounts by the auditor. He must certify that the profit and loss account and the balance sheet of his client show true and fair view of the financial position. These audits are of different types which we will discuss in this unit. This classification is done on the basis of organisational structure or practical approach to the work. This unit will help you in acquiring knowledge about the different types of audit as well as their merits and demerits.

2.3 CLASSIFICATION OF AUDIT ON THE BASIS OF ORGANISATIONAL STRUCTURE

In this section we will discuss the different classes of audit which are classified on the basis of organisational structure.

The following are the main classes of audit on the basis of organisational structure:

- Audit under statute
- Audit of the accounts of private firms
- Audit of accounts of private individuals
- Audit of the accounts of trustees and executors
- Government Audit

Audit under Statute

Audit is compulsory in case of the following undertakings under different laws that govern them.

(a) Joint stock companies incorporated under the Companies Act, 1956.

(b) Banking companies governed by Banking Companies Regulation Act, 1949.

(c) Insurance companies governed by the Insurance Act, 1939.

(d) Cooperative societies registered under the Cooperative Societies Act, 1912.

(d) Public and charitable trusts registered under various religious and other Endowment Acts.

Classification of Audit on the basis of Audit Dimension:

1. Management Audit
2. Cost Audit
3. Tax Audit
4. Human Resource Audit
5. System Audit
6. Property Audit
7. Performance or Efficiency Audit
8. Environment Audit
9. Social Audit
10. Cash Transactions Audit
11. Government Audit
12. Secretarial Audit
13. Energy Audit
14. Other types of Audit including special purpose audit (e.g. ABC Audit, Audit of bonus computation etc.)

2.4 CLASSIFICATION OF AUDIT ON THE BASIS OF CONDUCT

In the above section we have discussed the classification of audit on the basis of organisational structure. Audit can also be classified on the basis of conduct i.e. practical approach to the work. In this section we will focus on this classification. On the basis of conduct of audit, audits can be classified as under-

A. Continuous Audit.

B. Periodical or final or complete Audit.

C. Interim Audit.

D. Procedural Audit.

E. Occasional Audit.

F. Standard Audit.

G. Partial Audit.

H. Balance Sheet Audit.

Let us first discuss continuous audit.

A. Continuous Audit: A continuous audit is one where the auditor or his staff visits the client at regular or irregular intervals during the financial year. In each visit, the auditor or his staffs checks each and every transaction. During each visit, the auditor checks the books of accounts to date as far as possible and at the end of the year; he checks the Profit and Loss Account and the Balance Sheet.

Merits of Continuous Audit:

- **Early and quick detection of errors and frauds**
  Under this type of audit, errors and frauds are detected at an earlier date as the auditor visit and check the accounts in detail at a regular interval.
- **Reduction in opportunities for committing fraud**
  Frequent visits of the auditor reduce the opportunities for committing frauds and if any frauds are at all committed the amount involved will be less and chances of recovering the amount is better.

- **Keeping the account staff active and regular**

  Regular visits of the auditor make the accounts staff active and compel them to keep the accounts regular.

- **Moral check**

  If the auditor pays surprise visit it will have considerable moral check on account clerks.

- **Efficient Audit**

  As the auditor visit the client several times during the day he gets a limited work to perform during each visit so that he can check the accounts with greater attention.

- **Knowledge of technical details**

  Since the auditor is in constant touch with the accounts, the auditor is in position to know the technical details of the concern and can perform his work more efficiently.

- **Preparation of interim accounts**

  When the Directors of the company wish to declare an interim dividend, continuous audit will help in the preparation of interim accounts without much delay.

Demerits of Continuous Audit:

- **Expensive system of audit :**

  As the continuous audit is required to be carried out throughout the year, it becomes an expensive system.

- **Alteration of figures already checked:**

  After the accounts have been checked, the staff of the client may fraudulently alter the figures.

- **Dislocation of client's work:**

  Frequent visits by the auditor for checking the books of accounts and related documents may dislocate the work flow of the organisation.

- **Queries may remain unanswered:**

  Since the work is not completed at a time, the auditor may lose continuity and certain queries may remain unanswered.

- **Unhealthy relationship:**

  Frequent visits and disturbances in the daily work may provide scope for unhealthy relationship between the audit staff and the client's staff.

- **Reviewing of work already done:**

  Before starting the audit work, a review of the findings of the previous audit work should be made to establish the link with the past work done.



CHECK YOUR PROGRESS

Q 1: Mention two merits and demerits of continuous audit.

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B. Periodical Audit : A periodical or final or completed audit is one which is not commenced until after the end of the financial period and is then carried on until completed. Such a form of audit is very convenient for small business houses. In large business a completed audit is rarely practicable as the time required to complete audit would be considerable thereby delaying the presentation of audited accounts beyond a reasonable period.

According to Spicer and Pegler, "A final or complete audit is commonly understood to be an audit which is not commenced until after the end of the financial period and is then carried on until completed."

Advantages of Periodical Audit:

- **Avoids alteration of figures**

  As the audit work is completed at a stretch there is a little possibility on the part of the accounts staff to alter figures.

- **Inexpensive**

  As the auditor visits only once he will try to settle all queries during the same visit and nothing will be left outstanding.

- **Avoidance of monotony of work**

  As the audit work is finished within a reasonable period, monotony of work is avoided.

- **Extensive notes not necessary**

  As the audit work is completed in a single visit extensive note to keep the track of the work is not necessary.

- **No dislocation of work**

  As the auditor visits once there is a little dislocation of regular work of his client.

- **Requirement of small establishment**

  The auditor is not required to maintain a big establishment for this purpose.

Disadvantages of Periodical Audit:

- **Early detection of errors and frauds not possible**

  As the auditor commences his work at the end of the year after the accounts are prepared, errors and frauds can be detected earlier.

- **No detail checking possible**

  As the auditor completes the audit in a reasonable period, he cannot undertake detailed checking of the transactions. Thus errors and frauds may remain undetected.

- **Monotony in work**

  When the audit continues for a considerable period as in a large business the audit staff may suffer monotony in work.

- **No innovation in work**

  As the audit work is to be finished in one visit, the auditor does not feel it necessary to make any innovation in his audit work.

- **Delayed publication of annual report**

  When the number of transaction is voluminous, the auditor may take a considerable period to complete the audit. Thus, there may be delay in publication of annual reports.

- **Inefficient Audit**

  As the auditor has to rely on the internal checking system and the statements of the management in most of the cases, the audit report may fail to reflect the true position of the business.

- **Unsuitable for large business concerns**

  This type of audit is not suitable for big business concerns where the volume of transaction is large as it will take a long period to complete the audit.

C. Interim Audit: Interim audit is one which is conducted in between two annual audits in order to ascertain interim profits or loss or state of financial affairs of the concern. As for example, the directors of the company may desire to declare interim dividends for six months. In that case the audit of the accounts may be necessary to ascertain the true profit for that period. This kind of audit involves a complete checking of the accounts prepared for that period. It makes the final audit easier. It is an audit conducted in between two balance sheet audits.



CHECK YOUR PROGRESS

Q 2: Define interim audit.

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Internal Audit

Internal audit is the independent appraisal of activity within an organisation for the review of accounting, financial and other business practices. Internal auditors are the employees of the organisation. It acts as a protective and constructive arm of management. It measures and evaluates the effectiveness of other types of control. It is conducted by an assigned staff and as a management control. So the internal audit has been defined as “a review of operations and records, sometimes continuous, undertaken within a business by specially assigned staff”.

External Audit

External audit is conducted to fulfil the requirement of the provisions of law. It is conducted by an independent external auditor. Qualified chartered

accountants who are not connected with the preparation of accounts of the organisation can be appointed as external auditor. The external auditor is independent of the enterprise under audit. The various matters relating to the procedures of audit, rights, duties and liabilities of the auditor, their appointment procedures and presentation of reports are provided in the concerned statute.

D. Procedural Audit: It is the process of examination and appraisal of procedures adopted in maintaining the accounts of an organisation. It is the part of the whole audit procedures. It increases the reliability.

E. Occasional Audit: Usually it is not used. But it is applied by the sole trader organisation and partnership firm only upon the will of their client. Occasional audit is conducted in the following situation:

i. Conversion of Single Entry into Double Entry.

ii. When assets and liabilities are required to be revalued on admission, retirement or death of a partner.

iii. When the goodwill is required to revalue.

iv. When the traders are required to submit tax returns.

F. Standard Audit: The standard means measurement of certain thing under established rule by certain authority of specific quantity, value, weight etc. Thus, under standard audit certain items are thoroughly checked and analysed which controls the documents important for the purpose of audit.

G. Partial Audit: The partial audit is not permitted under company law as it curtailed the normal work of an auditor. It serves specific interest of a client. The auditor is asked to check a few books.

H. Balance Sheet Audit: This audit means the verification of the values of assets, liabilities, the balances of reserves, profit or loss suffered etc. In balance sheet audit, the balances of balance sheet items of previous year are linked up with the corresponding transactions of the current year and compare the different changes. Here the auditor is responsible to check the balance sheet and the profit and loss account are match with the books of accounts and returns.



2.5 LET US SUM UP

In this unit we have discussed the following aspects-

- A continuous audit is one where the auditor or his staffs visits the client at regular or irregular intervals during the financial year.
- A periodical or final or completed audit is one which is not commenced until after the end of the financial period and is then carried on until completed.
- Interim audit is one which is conducted in between two annual audits in order to ascertain interim profits or loss or state of financial affairs of the concern.
- External audit is conducted to fulfil the requirement of the provisions of law.
- The partial audit is not permitted under company law as it curtailed the normal work of an auditor.



2.6 FURTHER READINGS

1) Kumar R. & Sharma V. (2005), *Auditing : Principles and practice.* New Delhi, Prentice Hall of India Pvt. Ltd.

2) Tandon B.N., Sudharsanam S. & Sundhprabha S. (2010). *A handbook of practical auditing*. New Delhi, S. Chand & Co. Ltd.



2.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Merits of Continuous Audit:

i. Early and quick detection of errors and frauds

Under this type of audit, errors and frauds are detected at an

earlier date as the auditor visit and check the accounts in detail at a regular interval.

ii. Keeping the account staff active and regular

Regular visits of the auditor make the accounts staff active and compel them to keep the accounts regular.

Demerits of Continuous Audit:

i. Expensive system of audit:

As the continuous audit is required to be carried out throughout the year, it becomes an expensive system.

ii. Alteration of figures already checked:

After the accounts have been checked, the staff of the client may fraudulently alter the figures.

Ans to Q No 2: Interim audit is one which is conducted in between two annual audits in order to ascertain interim profits or loss or state of financial affairs of the concern.



2.8 MODEL QUESTIONS

Q 1: What is continuous audit? State the merit and demerits of such audit.

Q 2: What do you mean by interim audit? State its merit and demerits.

Q 3: State the different classification of audit on the basis of conduct.

Q 4: State the different classification of audit on the basis of organisational structure.

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Unit 3: SPECIAL AREAS OF AUDIT

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Concept and Objectives of Cost Audit

3.4 Features of Cost Audit

3.5 Difference between Financial Audit and Cost Audit

3.6 Meaning and Objectives of Management Audit

3.7 Scope of Management Audit

3.8 Origin of Tax Audit

3.9 Meaning and Concept of Tax Audit

3.10 Objectives of Tax Audit

3.11 Scope of Tax Audit

3.12 Auditor's Responsibility Regarding Tax Audit

3.13 Let Us Sum Up

3.14 Further Readings

3.15 Answer To Check Your Progress

3.16 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the concept of Cost audit, its objective and features
- differentiate between Financial and Cost audit
- explain the meaning and objectives of Management audit
- discuss the scope of Management audit
- explain the meaning and importance of Tax audit
- understand the Legal Provisions regarding Cost, Management and Tax audit.

3.2 INTRODUCTION

An audit is a systematic and independent examination of books, accounts, statutory records, documents and vouchers of an organization to ascertain to ascertain how far the financial statements as well as non-financial disclosures present a true and fair view of the concern and presented as required by law. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. Though audit is mostly understood as financial audit, but an organisation is today ridden with a number of audits – Cost audit, Management audit, Tax audit, Government audit, Internal audit, Social audit, Energy audit, etc. Such audits are evolved to find out the overall true and fair picture of an organization in all aspects.

3.3 CONCEPT AND OBJECTIVES OF COST AUDIT

Cost audit helps to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product. Therefore, cost audits can be used to the benefit of management in the fixation of selling price of the products.

The Institute of Cost Accountants of India defines cost audit as "a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries."

Thus the concept and scope of cost audit as defined in India is specific and lays emphasis on the evaluation of the efficiency of operations and the propriety of management actions as introduced by the Government of India for specified industries.

History of Cost Audit in India

In India, methods and techniques of cost accounting and audit of cost accounts can be traced back to pre-independence era when a large number of firms were given contracts by the Government of India on cost

plus basis. The Government then started verifying and investigating into the cost structure of such firms. This trend continued on a large scale during World War II that led to the recognition of cost as a distinct concept not only in India but also in the industrial economies of the world.

In the initial phase of industrial development of the country, there was an acute shortage of goods & materials, as well as, majority of inputs and resources for the production/manufacture of various capital & consumer goods. In the face of scarcity and shortage of almost all the inputs, products and services, Government had to resort to a policy of permits and licensing. A mechanism of Cost audit and maintenance of structured cost data were considered as important instruments in the hands of the regulatory authorities to monitor, control and regulate the efficient use of scarce resources and inputs so made available and monitor cost of production and administer prices. Thus, Cost Audit as a unique feature of corporate management in India emerged.

The Institute of Cost and Works Accountants of India (now The Institute of Cost Accountants of India) was later incorporated as a statutory body by an Act of Parliament in 1959.

Objectives of Cost Audit

Cost audit involves verification of cost accounts with a view to ascertain that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.

Cost Audit is carried out with following objectives:

- Ensuring that the prescribed procedures of cost accounting records rules are duly adhered to detection of errors and frauds.
- Verification of the cost of each “cost unit” and “cost center” to ensure that these have been properly ascertained.
- Determination of inventory valuation.
- Facilitating the fixation of prices of goods and services.
- Periodical reconciliation between cost accounts and financial accounts.
- Ensuring optimum utilization of human, physical and financial resources of the enterprise.

- Detection and correction of abnormal loss of material and time.
- Inculcation of cost consciousness.
- Advising management, on the basis of inter-firm comparison of cost records, as regards the areas where performance calls for improvement.
- Promoting corporate governance through various operational disclosures to the directors.

3.4 FEATURES OF COST AUDIT

The cost audit of the companies is featured under the relevant provisions of the Companies Act, 1956:

(i) Assessing compliance of the relevant cost accounting records rules as applicable to the product under review;

(ii) Study of the costing system to assess whether it is adequate for the cost ascertainment of the product under review;

(iii) Evaluation of the operating and other efficiencies of the organization under audit with special reference to the product under review; to ensure the submission of necessary details required under the Cost Audit Report Rules, as amended from time to time.

(iv) Submission of Cost Audit Report in the format prescribed.

Since cost audit is carried out under the provisions of the Companies Act, 2013, a thorough and comprehensive knowledge of the Indian Companies Act including various rules prescribed there under and the circulars issued by the Ministry of Corporate Affairs is essential for conducting an effective Cost Audit.

3.5 DIFFERENCE BETWEEN FINANCIAL AUDIT AND COST AUDIT

Financial Audit is the examination of financial records and business accounts by an independent body which is conducted for compliance, taxation or for disclosure purposes and ensures high accuracy in the given reports.

Cost Audit is the verification of accounts and cost records, and a careful compliance to cost accounting process.

Difference between Financial Audit and Cost Audit

Financial Audit	Cost Audit
Financial audit is mandatory for all companies registered under Companies Act, 1956.	Only in case of companies involved into manufacture or mining business and required to maintain Cost Accounts as per Section 209.
The financial audit is done to report on the financial data, consisting of a statement of balance sheet and profit and loss to ensure fairness of business perspectives.	Cost audit is done to certify after careful examination or checking of reports on expenditure made on production of intended items.
Financial Auditor is appointed by shareholders.	Cost Auditor is appointed by the board of directors with the previous approval of the Central Government.
Financial audit is mandatory to be conducted every year.	Cost Audit is conducted in a year in which audit is required by the government.
Financial audit is done or conducted as per the demand of the shareholders.	Cost audit is done when government or industrial organization proposes to make an audit.
Financial auditor has to check or examine carefully and in detail the exact value of closing the stock for the purpose of balance sheet.	In cost, audit the auditor has to see whether there is sufficient stock maintaining in order to fulfill the needs of the business concern. The cost auditors have to give their remarks
The financial auditors have to give their remarks about the exact expenditures shown on the record.	about how correctly or wisely the decisions have been taken in production of items. Cost auditor submits the report to the company and central government within
The finance auditor submits the report in annual general meeting organized by shareholders.	180 days from the end of financial year.



CHECK YOUR PROGRESS

Q 1: Define Cost Audit.

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Q 2: State two objectives of Cost Audit.

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Q 3: State two features of Cost Audit.

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3.6 MEANING AND OBJECTIVES OF MANAGEMENT AUDIT

In the case of a corporate body, audit involves examination of specific field of working viz. financial activities, organizational activities, management activities, social activities, etc. Each activity has a specific objective and responsibility and the function of Audit is to check and ensure fulfillment of responsibility delegated to the activity.

Management Audit is the total examination of transaction of an organisation, or parts of it, and includes checks on the effectiveness of managers, their compliances with company on professional standard, the reliability of management data, the quality of performance of duties and recommendations for improvement. In this context, the distinction between administration and management should be recognized.

Management audit is the unique process appraising the performance of directors, managers or in the other words, appraising the performance of the management. A working director is included as a manager for purposes of management audit.

According to William P. Leonard, “Management audit may be defined as a comprehensive and constructive examination of an organisation structure of a company and its plans and objectives, its means of operation and its use of human and physical facilities.”

Thus, management audit is the systematic examination, analysis and appraisal of management's overall performance. It is a form of appraisal of the total performance of the management by means of an objective and comprehensive examination of the organisation structure and its components. Management audit is concerned with evaluation and appraisal of the control system and information in the entire or in various segments of the organisation.

The objectives of Management audit are as follows –

- To appraise the management performance at all the levels;
- To spotlight the decision or activities, that is not in conformity with organizational objectives.
- To ascertain that objectives are properly understood at all levels.
- To ascertain that controls provided at different levels are adequate and effective in accomplishing management objectives or plans of operations.
- To evaluate plans which are projected to meet objectives.
- To review the company's organizational structure, i.e. assignment of duties and responsibilities and delegation of authority.

Thus main objective of Management audit is to review and strengthen the Internal Control system of an organization.

3.7 SCOPE OF MANAGEMENT AUDIT

The scope of management audit is decided by each organisation on its own needs. It has no limitations. It generally extends over all the resources deployed and commercial activities of the organization including Directors and their functions.

- Managers, supervisors and their functions.
- Organizational structure.
- Managers, supervisors and their functions.
- Organizational structure.
- Equipment and facilities, and their utilization
- Methods and systems.
- Security of information.

- Resources utilization – their adequacy and efficiency.
- Planning and control etc.

The scope of management audit extends over all the functions of an organisation viz. management, personnel, administration, material administration, marketing, finance, etc. wherever the effectiveness of management needs to be examined.

Accordingly, the scope of management audit may include –

(i) The suitability, practicability and present compliance or otherwise of the organisation with its desired objectives and aims.

(ii) The current image of the organisation among customers, general public within its own particular industrial or commercial field.

(iii) Efficient utilization of resources of the organisation.

(iv) The rate of return of investors' capital – whether poor, adequate or above average.

(v) Relationship of the business with its own shareholders and investing public in general.

(vi) Employee relation.

(vii) The aims and effectiveness of management at its various levels such as top level, middle level, and operational level.

(viii) Financial policies and control relating to production, sales and distribution and in other functions of the organization.



CHECK YOUR PROGRESS

Q 4: Define Management Audit**.**

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Q 5: Mention two objectives of Management Audit.

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3.8 ORIGIN OF TAX AUDIT

The concept of tax audit originated about six decades ago. In the year 1951, the Income Tax Investigation Commission submitted its report

suggested audit of business house of large income. Tax audit was introduced by section 11 of the finance Act, 1984, which inserted a new section 44AB with effect 1st April, 1985 in (Assessment Year 1985-86) audit of accounts of certain persons carrying on business or profession. Tax audit refers to the audit carried out under the provisions of section 44AB of the income tax Act1961.

The C.B.D.T explained the rationale in circular No.487 dated 6-7-1984. Indian tax audit is distinctive from other countries because, Tax audit by a Chartered Accountant is an Indian phenomenon and does not exist in any other country. This has broadened the area of practice by a Chartered Accountant to an unimaginable scale. The provision for compulsory 'Tax Audit' was introduced in order to curb 'Tax evasion'

3.9 MEANING AND CONCEPT OF TAX AUDIT

Tax audit is a systematic and independent examination of books of accounts to ascertain a correct picture of tax liability and to provide disclosures as per taxation law. It is an audit of accounts of a person u/s 44AB. This section makes it obligatory for a person carrying on business or profession to get his accounts audited by a Chartered Accountant and to furnish the report of such audit in the prescribed form by the specified date. Section 44AB of the Income-Tax Act provides for an audit of the accounts of an assessee whose turnover or gross sales exceeds Rs 1 crore per annum if the assessee is carrying on business or Rs 50 lakh of gross receipts if the assessee is carrying on profession.

Turnover shall exclude-

- Goods and Service Tax
- Trade Discount
- Goods returned
- Price adjustment
- Cancellation of bills
- Composite charges like delivery charges included in a good's price

But Includes-

- Bad debt and its provision
- Royalty

Tax auditing is a very valuable strategic function in taxation; it helps in checking whether taxpayers are complying with taxation statutes and hence helps to bring to light any irregularities in the taxation processes. Tax audit is a thorough examination of the financial statements to verify the correctness of calculation of taxable profit and to proper compliance with the provisions of Income tax Act i.e various income /expenses are required to be audited from the angle of Income tax by an accountant.

3.10 OBJECTIVES OF TAX AUDIT

Tax audit was introduced with the motive to ease the burden of Income Tax department official by shifting the burden of verifying the accuracy and correctness of the books of accounts of the taxpayer to Independent Accountants on their behalf.

Tax audit is being conducted to achieve the following:

- Ensure proper maintenance and correctness of books of accounts and certification of the same by tax auditor
- Reporting of observations/discrepancies noted by tax auditor after a methodical examination of books of account
- Reporting prescribed information such as tax depreciation, compliance of various provisions of income tax law etc. This in turn enables and also saves time of tax authorities in verifying the correctness of income tax return filed by the taxpayer such as total income, claim for deductions etc.

3.11 SCOPE OF TAX AUDIT

Tax Audit is an obligation on a person carrying on business or profession to get his accounts audited by a Chartered Accountant (CA), in case of business if his total sales, turnover or gross receipts in a financial year exceeds Rs. 1 crore**.** In case of Profession if the gross receipts exceed Rs.50 lakhs (increased from 25 lakhs wef A.Y. 2017-18). However, Sec 44AD

provides special provision for computing profits and gains of business on presumptive basis. If the turnover exceeds the limit of Rs.1 crore but up to Rs. 2 crore is having an option to avail the benefit of Section 44AD (1) and avoid the audit (As per the amendment made by finance act 2017). One need not maintain proper accounting if gross turnover/receipt does not exceeds Rs. 2 Crore. The net income is estimated to be @8% of gross receipt/turnover. From F.Y. 2016-17, net income is calculated as @6% of gross receipts are received through digital mode of payments and @8% of gross receipts are received in cash.

3.12 AUDITOR'S RESPONSIBILITY REGARDING TAX AUDIT

Prescribed Audit Forms

The audit report has to be furnished in either of the following forms:

- Form 3CA – In respect of a taxpayer carrying on a business or profession and who is already mandated to get his accounts audited under any other law *(i.e. law other than income tax law)*.
  A company is required to get its accounts audited compulsorily under Companies Act 2013. So, it will furnish Form 3CA.
- Form 3CB – In respect of a taxpayer carrying on a business or profession but who is not required to get his accounts audited under any other law.
  A proprietorship entity or partnership firm, having turnover of more than 1 crore and not opting for presumptive income scheme, is not required to get its accounts audited under any other law except income tax. So, it will furnish Form 3CB.
- Form 3CD - Along with either of the forms mentioned above, tax auditor shall also furnish Form 3CD which forms part of the audit report. Form 3CD is a 41-points detailed statement of particulars. All the details related to various aspects of the business and transactions have to be filled at appropriate places.
- Form 3CE - Non-residents and foreign companies receiving royalty or fees for technical services from the government or an Indian concern

have to get their accounts audited.The auditor will furnish the report in Form 3CE in such cases.

Signature on Auditors' report: Tax Audit Report should be signed by the CA in Practice mentioning the name of firm, name of the member signing, Membership No. and Registration Number of the firm (Applicable from 01.04.2010) as allotted to them by the Institute of Chartered Accountants of India.

Due Date: The **due** date for filing the return of income for persons liable to Tax Audit is 30th September of the year succeeding the relevant financial year. For the financial year ending on 31.03.2018 the due date is 30.09.2018.

Tax Audit report Submission:- If the assessee gets his account audited u/s 44AB and furnish the said report as required, than penalty under section 271B shall not be levied even if the return of income is filed after the due date specified u/s 139(1).

It is the professional duty of the CA to ensure that the audit accepted by him gets completed on or before the due date. If there is any unreasonable delay on his part he is answerable to the ICAI, if the client complains. However, if the delay in the completion of audit is attributable to his client, the tax auditor cannot be held responsible.

A CA in practice shall be deemed to be guilty of professional misconduct, if he accepts a position as auditor previously held by another CA without communicating with him in writing.

The opinion expressed by the auditor is not binding on the assessee. If the tax auditor has qualified his report and expressed an opinion on a particular item, the assessee may take a different view while preparing his return of income. In such cases it is advisable to the assessee to state his viewpoint and support the same by some judicial pronouncements.

Non Compliance:- If any person fails to get his accounts audited as required under the provisions of section 44AB before the due date u/s 139(1), the Assessing Officer may impose penalty which may be a sum equal to 0.5 percent of the total sales, turnover or gross receipts subject to a maximum of Rs. 1.5 Lakh.

However, according to section 273B, no penalty shall be imposed if reasonable cause for such failure is proved.

Situations considered as reasonable cause for non-filing of Audit Report u/s 44AB :

1. Resignation of tax auditor
2. Bona fide interpretation of the term 'Turnover' based on expert advice
3. Death or Physical inability of the partner in charge of accounts
4. Labour problems such as strike, lock out for a long period
5. Loss of books of accounts by theft, fire etc. beyond the control of the assessee
6. Non-availability of accounts on account of seizure
7. Natural calamities, commotion etc.



CHECK YOUR PROGRESS

Q 6: Mention two objectives of Tax Audit.

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Q 7: Mention the due dates of filing return of income for persons liable to tax audit.

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3.13 LET US SUM UP

- Cost audit helps to ascertain whether an organization's cost accounting records are so maintained as to give a true and fair view of the cost of production, processing, manufacturing, and mining of a product.
- Objectives of Cost Audit: Cost audit involves verification of cost accounts with a view to ascertain that these have been properly maintained and compiled according to the cost accounting system followed by the enterprise.
- Features of Cost Audit: Assessing compliance of the relevant cost

accounting records, Study of the costing system to assess whether it is adequate for the cost ascertainment of the product under review, Evaluation of the operating and other efficiencies of the organization under audit, Submission of Cost Audit Report in the format prescribed.

- Management audit is the systematic examination, analysis and appraisal of management's overall performance. It is a form of appraisal of the total performance of the management by means of an objective and comprehensive examination of the organisation structure and its components.
- Tax audit is a systematic and independent examination of books of accounts to ascertain a correct picture of tax liability and to provide disclosures as per taxation law. It is an audit of accounts of a person u/s 44AB.
- Tax audit was introduced with the motive to ease the burden of Income Tax department official by shifting the burden of verifying the accuracy and correctness of the books of accounts of the taxpayer to Independent Accountants on their behalf.
- The due date for filing the return of income for persons liable to Tax Audit is 30th September of the year succeeding the relevant financial year. For the financial year ending on 31.03.2018 the due date is 30.09.2018.



3.14 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). Principles and Practice of Auditing, New Delhi, Himalaya Publishing House.

3.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The Institute of Cost Accountants of India defines cost audit as "a system of audit introduced by the Government of India for the review, examination and appraisal of the cost accounting records and attendant information, required to be maintained by specified industries."

Ans to Q No 2: (i) Ensuring that the prescribed procedures of cost accounting records rules are duly adhered to detection of errors and frauds.

(ii) Verification of the cost of each "cost unit" and "cost center" to ensure that these have been properly ascertained.

Ans to Q No 3: (i) Assessing compliance of the relevant cost accounting records rules as applicable to the product under review.

(ii) Study of the costing system to assess whether it is adequate for the cost ascertainment of the product under review.

Ans to Q No 4: According to William P. Leonard, "Management audit may be defined as a comprehensive and constructive examination of an organisation structure of a company and its plans and objectives, its means of operation and its use of human and physical facilities."

Ans to Q No 5: (i) To appraise the management performance at all the levels;

(ii) To spotlight the decision or activities, that is not in conformity with organizational objectives.

Ans to Q No 6: (i) Ensure proper maintenance and correctness of books of accounts and certification of the same by tax auditor.

(ii) Reporting of observations/discrepancies noted by tax auditor after a methodical examination of books of account

Ans to Q No 7: The due date for filing the return of income for persons liable to Tax Audit is 30th September of the year succeeding the relevant financial year. For the financial year ending on 31.03.2018 the due date is 30.09.2018.



3.16 MODEL QUESTIONS

Q 1: What is Cost Audit? Explain the objectives of Cost audit.

Q 2: Discuss the features of Cost audit.

Q 3: What is the difference between financial audit and cost audit?

Q 4: Explain the concept of Management audit. What are its objectives and scope?

Q 5: What is the meaning of Tax audit and explain its importance.

Q 6: Describe the scope of tax audit.

Q 7: Discuss the Auditors duty regarding tax audit as per the provisions of law.

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UNIT 4: PREPARATION FOR AN AUDIT

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Considerations before Accepting Appointment as Auditor

4.4 Preparatory Steps before Commencement of Audit

4.5 Division of Work among Audit Staff

4.6 Preparations by Auditor

4.7 Let Us Sum Up

4.8 Further Readings

4.9 Answers To Check Your Progress

4.10 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the steps that an auditor should take before conducting audit work
- describe the duties of audit staff
- explain the meaning of audit planning and audit programming
- discuss the matters to be considered in preparing audit planning
- explain the advantages and limitations of audit programme
- discuss the meaning and importance of audit notebook

4.2 INTRODUCTION

In unit 1, we have discussed the origin of auditing as well as who is an auditor, qualities and duties of an auditor etc. In unit 2, we have come across the different types of audit, such as, continuous audit, periodical audit etc. In this unit, we will deal with another important aspect of auditing i.e. the preparatory steps that an auditor should take before starting the actual audit work.

When an auditor is appointed by an organisation, it is expected that the auditor should verify the financial records of the organization and give his comment regarding the truthfulness and fairness of the financial information. The auditor is responsible for detecting any fraud or error in the financial matters of the organization concerned. Therefore, the auditor should be cautious in performing his duties. He must take certain steps before accepting his appointment as an auditor in an organization and should prepare a plan for efficient performance of his work.

The discussion in this unit will help you in understanding the preliminary steps that an auditor should take before commencing the audit work. In this unit we will focus our attention on the preparatory steps that an auditor should take before accepting his appointment as an auditor as we as the preparatory steps that the auditor should take before commencing the audit work. Then we will discuss the meaning of audit planning, audit programme, audit note book and working papers. So you will come to know about these documents which are prepared by the auditor to conduct the audit work smoothly.

4.3 CONSIDERATIONS BEFORE ACCEPTING APPOINTMENT AS AUDITOR

An audit work consists of various steps. Audit is a systematic work and the auditor as a professional must adhere to certain professional norms. He must prepare a detailed audit plan for the proper execution of audit work. He must gather certain information regarding the nature of business of his client, the accounting system followed in the organization, the internal control system of the organization etc. Therefore, to equip himself with all the necessary information, he has to take certain preparatory steps in this direction. In this section we will discuss those steps that an auditor should take before accepting his appointment as an auditor.



Client: The organization who appoints an auditor and pays fee for his service.

- **Receiving appointment letter:** As a first step, the auditor should receive the appointment letter from the client. If he is appointed by a joint stock company, he must ensue that his appointment must be in accordance with the provisions of the Companies Act, 1956. The

appointment letter is known as Audit Engagement Letter. It spells out the scope of the audit work and the responsibilities of the auditor.

- **Communication with the existing auditor:** In case of a continuous business, if the new auditor is appointed in place of an outgoing auditor, the new auditor must communicate with the outgoing auditor regarding any objections on his appointment. This is a professional requirement as per the Institute of Chartered Accountants of India.
- **Acceptance of appointment:** If the outgoing auditor has no objection regarding the appointment of the new auditor, the newly appointed auditor can accept the appointment. The new auditor sends a letter of acceptance to confirm his acceptance of appointment.

4.4 PREPARATORY STEPS BEFORE COMMENCEMENT OF AUDIT

After accepting the appointment, the auditor starts preparation for the actual audit work. For this purpose, he must take certain preparatory steps before the actual audit commences. Let us discuss these steps-

- **Determining the scope of audit:** At this stage the auditor should determine the scope of audit work. In case of statutory audit, the auditor must refer to the statute to determine the scope of audit. In case of other types of audit, the auditor must consult with the client to determine whether a full audit is required or it is required for a specific purpose. The Audit Engagement Letter helps the auditor to determine the scope of his work. In case of any ambiguity, he can prepare a list of audit requirements and can consult the client.



Statute: An Act passed by the Legislature, for example, Companies act, 2013; Indian Contract Act, 1872 etc.

- **Determining the nature of client's business:** Before conducting the audit work, it is important for the auditor to acquaint himself with the business of the client. He can visit the location of the enterprise to familiarize himself with the nature of the organization, its activities and technical details. Some other sources from where the auditor can collect information about the client's business are –
  - Minutes of meetings of the shareholders, board of directors etc.;
  - Annual reports of the business;

- Previous year's audit working papers
- Internal financial management reports etc.



LET US KNOW

Internal control system refers to the system of control applied by the management of an organization to carry on the day to day business. It applies to all the activities of the organization like, production, distribution, accounting etc. It includes various methods, procedures, policies etc. Effective internal control system provides up to date information to the management which enable them to take decision at the appropriate time.

- **Knowledge of the accounting system:** The auditor should obtain all the books of accounts maintained by the client to record the business transactions and should examine the accounting system. He should verify the internal control system of the organization to determine its effectiveness and to what extent he can rely on that system.
- **Information about client's staff:** The auditor should obtain the list of principal officials of the organization stating the particulars of work performed by them, extent of their authority along with their specimen signature.
- **Instruction to the client:** After acquiring all the relevant information from the client, the auditor issues certain instructions to the client to facilitate the actual audit work. These instructions relate to-
  - Ledger posting and completion of ledger balancing;
  - Preparation of trial balance and final accounts;
  - Cash and bank pass books should be complete in all respects;
  - Vouchers should be filed date- wise;
  - Schedule regarding debtors, creditors, investment, outstanding income and expenses etc. should be prepared.

4.5 DIVISION OF WORK AMONG AUDIT STAFF

Audit work is quite complex which require consideration of different aspects like, casting of subsidiary books, checking of cash book balance, valuation of stock, preparation of audit report etc. Therefore, to perform the various sub- functions of audit work, it is necessary to apply the principle of division of work among the audit staff. The audit staff can be categorised as under-

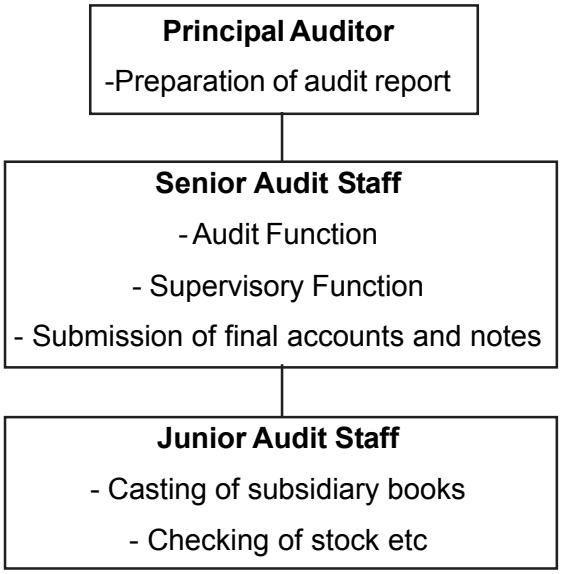


Figure: Division of work among audit staff

The number of staff required for an audit depends on the nature and size of the work. The principal auditor divides the audit work among the senior and junior audit staff. Let us discuss the functions performed by junior, senior and principal auditor-

Junior Audit Staff

The functions of junior audit staff mainly consist of checking of original records with documentary evidence, casting of subsidiary books, checking of stock and wage sheet etc. These functions are of routine nature and require less technical knowledge. The junior staff is trained by these preliminary audit works.

Senior Audit Staff

The work of senior audit staff generally consists of the following functions-

- **Audit Function:** Functions like, vouching of receipts and payments sides of cash book, verification of cash balance, apportionment of

capital and revenue, valuation of stock etc. are done by senior audit staff which require knowledge of accounting principles and its application;

- **Supervisory Function:** Senior audit staff also performs the supervisory function. He outlined the methods and procedures to be followed by junior staff;
- **Submission of final accounts and notes:** The senior audit clerk is responsible for submitting the final accounts with all the notes taken by him during the audit to the principal auditor.

Principal Auditor

The principal auditor studies the final accounts and the notes submitted by the senior audit clerk. If he is satisfied that the accounts are properly drawn and show a true and fair view of the client's financial position, he writes the audit report and signs it. The principal auditor is responsible for all the audit work.

4.6 PREPARATIONS BY AUDITOR

An auditor, after taking the preparatory steps for conducting the actual audit work, is now ready to begin his work. In this respect, the auditor should be ready with the following-

- **Audit planning:** Audit planning is concerned with deciding in advance what is to be done, who is to do it, how is to be done and when it is to be done. The audit function is comprises of various aspects like, vouching, verification, valuation etc. Effective and smooth performance of all these functions requires proper planning and continuous monitoring. Hence, audit planning is done with the objective of conducting the audit efficiently. Audit plan should be reviewed continuously which helps the auditor in –
  - giving proper attention to the important areas of audit;
  - identifying potential problems;
  - completion of work in time;
  - efficient utilization of audit staff;
  - coordinating the work of other auditors and experts.

The auditor should prepare audit plan taking into consideration the following aspects-

- terms and conditions stated in the audit engagement letter;
- relevant statutory requirements;
- nature and timings of reporting;
- important audit areas;
- reliability of internal control system etc.

- **Audit programme:** Audit programme is the layout of the work done by the auditor. The auditor prepares the details of the work to be done by encompassing the techniques and procedures to be applied in completing the assigned audit work. Audit programme is prepared by considering certain factors like, extent of work to be done, allocation of work to the audit staff, allotting specific time for the assigned work etc. The advantages of audit programme are-
  - **Completion of work:** Audit programme helps in completing the work efficiently. It provides a guideline to the auditor and his staff to consider all the necessary areas for auditing.
  - **Progress of work:** The auditor is in a position to determine the progress of audit work done by his staff at any point of time.
  - **Delegation of work:** Audit programme helps the auditor in delegating the work to his staff and accordingly they can be held responsible for the assigned work.
  - **Final review of work:** The auditor before signing the report can review the audit work with the help of the audit programme.

  However, audit programme is not without limitations. Some of the limitations can be stated as under-
  - **Loss of initiative:** An efficient staff may lose his initiative by following the audit programme.
  - **Rigidity:** The same audit programme can not be implemented for all types of business. This is because every business has its own problem and may follow different accounting system.
  - Audit programme, if followed mechanically may result in non inclusion of emerging areas during the course of audit.

- **Audit notebook:** Audit notebook refers to the record of important facts that has come up during the course of audit. Therefore, the auditor can make a reference of that in future. In audit notebook, the auditor record those matters-
  - for which he has not received satisfactory reply from the client; and
  - which require to be incorporated in the **audit report**

  The audit notebook contains information like,
  - list of books of accounts maintained by the client;
  - names of principal officers, their powers, duties etc.
  - the matters which require further explanation;
  - particulars of missing vouchers, errors etc.
  - accounting method and financial policies followed etc.

  The advantages of preparing audit notebook are-
  - it helps in preparation of audit report;
  - it acts as legal evidence if the auditor has to defend himself against the charge of negligence;
  - it is a source for future reference;
  - it ensures that audit programme has been followed properly; etc.
- **Audit working papers:** Audit working papers are the documents collected by the auditor during the course of audit. They relate to the essential facts about the audited accounts and certain basic information of the business firm. Audit working papers contain the information supplied by the client and the methods and procedures applied by the auditor in verifying the client's accounts. It helps the auditor in preparing the audit report.
- **Classification of audit working papers:** Working papers are classified as current file and permanent file. Current file contains copy of accounts, on which the auditor is reporting, a schedule for each item in the balance sheet and profit and loss account, audit programme, copies of communication with other auditors, experts and third parties etc.



Audit Report: The document through which the auditor gives his opinion regarding the authenticity of the client's financial statements audited by him.

Permanent file contains a copy of Memorandum of association, Articles of Association, Partnership Deed etc., a description of nature of business carried on by the client and facts of business, notes regarding accounting policies etc.



LET US KNOW

The Institute of Chartered Accountants of India issues certain auditing standards from time to time which are required to be followed by the members when discharging their duties as auditor. These standards are collectively known as Engagement Standrds and Quality Control Standards. Some of these standards are-

- SA 210: Agreeing the Terms of Audit Engagements
- SA 220: Quality Control for an Audit of Financial Statements
- SA 230: Audit Documentation, etc.



CHECK YOUR PROGRESS

Q 1: What is audit planning? (Answer in 3 lines)

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Q 2: State two advantages of audit programme.

i) .....

ii) .....



4.7 LET US SUM UP

In this unit we have discussed the following aspects –

- Audit is a complex job and it requires systematic approach by the auditor.

- The auditor must fulfill professional norms while discharging his function as auditor.
- Before accepting the appointment as an auditor, he must communicate with the retiring or the outgoing auditor for any objection on his part.
- The appointment letter of the auditor is known as Audit Engagement Letter.
- Before commencing actual audit work, the auditor must take the preliminary steps like, determine the scope of audit work, understanding the nature of client's business and the accounting system in practice etc.
- The principal auditor must divide the audit work among the senior and junior audit staff to complete the work efficiently.
- The principal auditor prepares the audit report and put his signature which ensures that the accounts and other financial statements shows true and fair view of the financial position of the client.
- Though audit work is divided among audit staff, the principal auditor is responsible for the whole audit work.
- The auditor prepares the audit planning, audit programme, audit note book etc.



4.8 FURTHER READINGS

1) Basu S. K. (2008). *Auditing : Principles and techniques.* New Delhi, Pearson Education Ltd.

2) Gupta K. (2005). *Contemporary Auditing.* New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). *Principles and practice of Auditing*. New Delhi, Himalaya Publishing House.

4.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) Audit planning is concerned with deciding in advance what, who, how and when audit work is to be done. It provides the guideline to the auditor to finish his work efficiently. Audit planning should be reviewed continuously.

Ans to Q No 2: a) Completion of work in time.

b) It helps in delegating the work.



4.10 MODEL QUESTIONS

Q 1: Discuss the steps that an auditor should take before accepting the appointment.

Q 2: Discuss the preparatory steps that an auditor should take before the actual audit work.

Q 3: Discuss the division of work among audit staff.

Q 4: Write short notes-

i) Audit planning

ii) Audit notebook

iii) Working papers

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UNIT 5: TEST CHECKING

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Meaning and Need of Test Checking

5.4 Precautions to Be Taken Before Applying Test Checking

5.5 Meaning and Features of Internal Check

5.6 Objectives of Internal Check System

5.7 Auditor's Position Relating to Internal Check

5.8 Let Us Sum Up

5.9 Further Readings

5.10 Answers To Check Your Progress

5.11 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the meaning and need of test checking
- explain the precautions taken by the auditor before applying test checking
- explain the features of internal check system
- describe the objectives of internal check system
- analyse the position of an auditor in relation to internal check.

5.2 INTRODUCTION

In this unit we are going to discuss about test checking and internal check. These two aspects facilitate the auditing work. In a business organization large number of transactions takes place every day. The auditor is required to check these transactions and he has to certify the accuracy of the financial statements of the organization. But detailed checking of each and every transaction will increase the cost and more time will be required to complete the work. Therefore, the auditor can apply test check. It means

the auditor can select certain transactions randomly and can check these transactions in detail. In this case, the internal check system can help the auditor. Internal check is the system by which the duties of the staff are so arranged that the work done by one person is automatically checked by another. Thus, it prevents frauds and existence of an effective internal check system helps the auditor in examining the books of account. In this unit we will discuss the meaning, importance and features of these two important aspects. We will also cover the auditor's position in relation to these aspects.

5.3 MEANING AND NEED OF TEST CHECKING

Test checking or judgemental sampling means selecting and checking only a few transactions for the purpose of arriving at the judgement as to the whole set of transactions, books, vouchers etc. The usual practice is that a representative number of entries of each class is selected and checked and if they are found correct the remaining entries are also taken as correct. The totality is termed as the universe or population and the portion of the universe or population to be examined is called sample. All items of one type form a universe and the samples should be selected at random from each universe. The test checking is based upon the theory of probability which states that a sample selected from a group of items (i.e universe) will tend to show the same characteristics present in the full series of the items. Therefore, the selection of items and extent of test checking would mainly depend upon the auditor's judgement and assessment of a particular situation.

Thus, test checking implies limiting the auditor's examination of every transaction entered by his client in the books of accounts to certain test of the internal control and the data in the financial statements. It involves a more intensive checking of a limited number of transactions selected at random from the total accounting data as against a detailed checking of all the transactions.

For example, the audit programme relating to a middle sized enterprise may contain one of the following instructions.

a) Check 25 percent of the posting from journal to the ledger or

b) Select any three months (sometimes, even the months are specified) and check 100 percent posting from journal to ledger relating to transactions of these months.

It is obvious that in the above situations auditor is not carrying out an examination of 100 percent of all the transactions of the business house. Instead he is resorting to selective examination through test checking or judgemental sampling.

Prof Meig defines : Testing and test checking means to select and examine a representative sample from a large number of similar items.
Test checking can be of immense help to the auditor as it will reduce his routine work and he can devote his time in the more important sections of the work. It should be remembered that test checking does not relieve an auditor from his liability, if in future mistakes are detected.

The objectives of audit are the verification of accounts and detection of and prevention of frauds and errors. In order to fulfill these objectives the auditors has to check the books of accounts. However, in a large business organisation it is neither necessary nor practicable for the auditor to verify each and every entry in the books of accounts. Detailed checking increases the cost of audit disproportionately as well as the process of detailed checking consumes so much time that the audit work cannot be completed in scheduled time. Detailed checking is also unnecessary from that point of view that accuracy of accounts to a great extent is ensured through the effective application of internal control. L.R. Dicksee supports this view in his book “Auditing” in the following lines... The theoretical responsibility of an auditor extends automatically to every entry in the books of accounts but it does not follow that it is neither necessary nor possible to examine every entry in details. Therefore, the auditors resorts to a form a selective verification of transaction in such a manner that he can draw conclusions about all the transactions as a whole.

5.4 PRECAUTIONS TO BE TAKEN BEFORE APPLYING TEST CHECKING

The following precautions are to be taken by an auditor before a test checking is applied.

1. **Review of the system of internal control :** The auditor must review the whole system of internal control including internal check and internal audit prevalent in the organisation. If the internal control system is not adequate or not reliable he should not resort to test checking.
2. **Representative sample :** Entries selected for the test checking should be representative of the whole, and the entries of every description must be tested.
3. **Homogeneous nature of items :** The auditor can apply test checking if he finds that the transactions to be checked are homogenous in nature.
4. **Selection of items at random :** Selection of items to be checked should be at random.
5. **Coverage :** The test checking must cover the work of every clerk/ official connected with the maintenance of accounts.
6. **Unbiased selection :** In the selection of items of transactions for test checking there should not be any element of bias or arbitrariness.
7. **Cash Book :** Cash book should not be subject to test checking i.e. cash book should be thoroughly checked.
8. **Transactions of the first month and the last month :** A number of entries of the first and the last month of the period covered by accounts should be checked.
9. **Surprise verification :** It must contain an element of surprise verification and the auditor should always change the methods of test checking.
10. **Secrecy :** The methods of test checking should be kept secret from the client's staff.



CHECK YOUR PROGRESS

Q 1: State the precautions that auditor should take before applying test check.

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5.5 MEANING AND FEATURES OF INTERNAL CHECK

The system of internal check refers to the system of arranging the duties of the members of the organization in such a way that the work performed by one person is automatically and independently checked by another person. The transactions of routine nature are arranged in such a manner that each and every transaction is checked more than once. Hence, the work of each person is crossed checked. An effective internal system helps in preventing frauds or facilitates early detection of fraud.

Features of Internal Check :

The following are the important features of a good internal check system.

1. **Well defined responsibilities :** The responsibility of each employee of the organisation must be properly defined and fixed. The work of the business should be allocated among the various working staff in such a manner that their duties and responsibilities are clearly and judicatory decided and there may not be left any room for interference.
2. **Clear written instruction as regards the procedure of each job:** There should be clear written instructions as regards the procedures to be followed in carrying out each job.
3. **Rotation of employees :** A system of transfer or rotation of employees from one seat of work to another must be followed by the business, so that no one is allowed to continue the same job for a long period.
4. **Assignments of a part of a job to a person :** Each job should be so divided in such a way that no single person is allowed to complete the work by himself from the beginning to the end.

5. **Automatic check :** An efficient system of internal check should provide for an automatic checking of the work of one clerk by another.
6. **Reliance :** No clerk of the business house should be relied on too much.
7. **Proper system of filing :** There should be a proper system of filing vouchers, correspondence etc.
8. **Proper record of important documents received :** A responsible official should be entrusted with receiving important letters, money orders, registered envelops etc. and to record these in a proper register and then passed on to the clerks concerned.
9. **Ecouroging leave :** Person dealing with cash securities, cheque etc. should be encouraged to go on leave. It will help in detecting concealed frauds.
10. **Introduction of self balancing system :** Machanised accounting system of self balancing system should be introduced for making the system of internal check efficient and successful.



CHECK YOUR PROGRESS

Q 2: State three features of internal check.

i) .....

ii) .....

iii) .....

5.6 OBJECTIVES OF INTERNAL CHECK SYSTEM

The following are the objects of internal check system.

i) **To face responsibility of an act :** To allocate duties and responsibility of every clerk in such a way that there is proper division of work and responsibility for an error or fraud can be easily fixed.

ii) **To minimize the chances of error and frauds :** Internal check system provides an independent device of checking the work of one person by another or more persons, therefore the chances of committing errors, mistakes and frauds are minimized.

iii) **To facilitate early detection of errors and frauds:** Internal check system facilitates early detection of errors and frauds where these are committed.

iv) **To enhance efficiency of clerks :** The effiency of the clerks are enhanced as the assignment of duties is based on the principle of division of labour.

v) **To provide check against ommission of transactions** from being recorded. As recording of a transaction involves the work of two or more persons the possibility of omission of recording a transaction is checked.

vi) **To exercise moral pressure over the staff :** Internal check exercises moral pressure over the staff since it reduces the temptation for committing frauds by making commission of fraud difficult and detectable.

vii) **To ensure that accounting system produces reliable information :** As the work of a clerk is automatically checked by another clerk the accounting system ensures reliable information.

viii) **To prevent misappropriation of goods and emblesssment of cash**.

ix) **To prepare final accounts with ease and efficiency :** To prepare final accounts with ease and efficiency as an efficient system of internal check makes accounts regular and reliable.



CHECK YOUR PROGRESS

Q 3: State three objectives of internal check.

i) .....

ii) .....

iii) .....

5.7 AUDITOR'S POSITION RELATING TO INTERNAL CHECK :

The main objective of a statutory auditor is to certify the accuracy and truthfulness of the books of account and the financial statements. To achieve this objective the auditor is required to examine the books of

accounts and other necessary and relevant records. While concluding such examination the auditor is generally helped by an efficient internal control system. The auditors position in relation to internal check can be discussed as under.

1) **Where the internal check system is sound and efficient :** If the internal check system is sound and effective the work of an auditor becomes quite easy and he may be relieved of detalied checking of the transactions which is automatically taken care of by a good system of internal check. But before he relies upon the internal check, he must ensure the scope and effectiveness of the internal check system in operation for this purpose. For this purpose the auditor must test check the efficiency and soundness of the system by the application of procedural test to different types of transaction. If he is satisfied about the effectiveness of the system, he may, to a great extent rely on the accuracy and correctness of the books of accounts and other relevant records. However, if he comes across any mistake, he should investigate the nature and cause of such mistake. If in his opinion such mistakes are accidental and unintensional and the books of accounts represent a true and fair of the state of affairs of the business he may apply test check to verify books of account and may be relieved from checking each and every transaction of the business organisation.

2) **When there is sufficient ground for suspicion :** If there is sufficient reason and ground to suspect fraud, misappropriation of goods and emblessment of cash, the auditor should go deep into the matter and resort to detailed checking.

3) **Where the system is inadequate in certain areas only :** If the auditor finds that the internal check system in force contain some loopholes in certain areas only, he should check the records exhaustively in those areas of weakness and resort to detailed check in other parts as far as possible. The auditor should report such loopholes to the authorities and offer suggestions to improve the system.

4) **Where the system is faulty and not at all reliable :** Where the existing system of internal check is faulty and not reliable at all, he should mention it clearly in his report and should disown the responsibilities that may arise from the defects in the system. He should suggest measures to improve the internal control system and make it effective, sound and reliable and he should also see that the suggestion are duly implemented. However, if his suggestions are not implemented he should make it clear to the appropriate authority that he would not be responsible for any discripency arising out of such account and records.

5) **Where there is no internal check system :** Where there is no internal check system in the organisation and the clerk has full control over all the books of accounts, as in case of a small business organisation, the auditor should check all the transactions from the beginning to the end. The process of checking each and every transaction will obviously take more time but it will be worth doing so. The auditor should not assume that the books of accounts are free from errors. If he does so he would be running a great risk because in the event of any mistake or fraud being discovered subsequently in the areas of account which the auditor has accepted to be correct, he may be held guilty of negligence regardless of the fact that he relied upon the internal checking system prevalent in the organisation.



ACTIVITY 1

A) Analyse the position of an auditor in respect of test check and internal check.

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5.8 LET US SUM UP

The system of internal check in a business organisation largely determine the nature and extent of the scope of an auditor work. It determines the reliance which an auditor can place on test checking. A good system of internal check may relieve the auditor from detailed checking and hence saving valuable time, that can be devoted to more important works. But if the system is found to be defective, it is the duty of the auditor to check the transactions in detail because the ultimate responsibility in case anything goes wrong subsequently, lies on the external auditor. A good system of internal check reduces the work of an auditor, however, it dose not reduce his responsibilities, as the auditor cannot be relieved of his liabilities on the ground that since the system of internal check was good, he did not perform a particular function. Therefore, to what extent he should rely upon the system of internal check will depend upon his skill, experience and training.



5.9 FURTHER READINGS

1) Kumar R. & Sharma V. (2005). *Auditing : Principles and practice.* New Delhi, Prentice Hall of India Pvt. Ltd.

2) Tandon B.N., Sudharsanam S. & Sundhprabha S. (2010), *A handbook of practical auditing*. New Delhi, S. Chand & Co. Ltd..



5.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) The auditor must review the systems of internal check and internal audit.

ii) The method of test checking should be kept secret.

iii) The auditor must select the sample randomly.

Ans to Q No 2: i) Fixing the responsibility of employees.

ii) Written instruction for carrying out each job.

iii) Assignment of a part of a job to a person.

Ans to Q No 3: i) to minimize the chances of errors and frauds.

ii) to enhance the efficiency of clerks

iii) to ensure that accounting system produces reliable information.

5.11 MODEL QUESTIONS

Q 1: What is test checking? Discuss its importance in auditing.

Q 2: What precautions an auditor should take before applying test check?

Q 3: Discuss the feature and importance of internal check.

Q 4: Explain the auditors' position in relation to internal check.



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UNIT 6: VOUCHING

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Meaning of Vouching

6.4 Vouching of Cash Receipts

6.5 Vouching of Cash Payments

6.6 Collection of Book Debts

6.7 Dividend Received

6.8 Sale of Investment

6.9 Goods Sold on Hire Purchase System

6.10 Insurance Premium

6.11 Let Us Sum Up

6.12 Further Readings

6.13 Answers To Check Your Progress

6.14 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning of vouching
- describe about vouching of cash receipts and cash payments
- discuss the vouching of collection of book debts, dividend received, sale of investment, goods sold on hire purchase system and insurance premium.

6.2 INTRODUCTION

In this unit, we are going to discuss the different aspects of vouching. It is the process of examining documents by the auditors of different transactions. These documents may be the invoices, minutes etc. Here, you will able to know the vouching of cash receipts and cash payments. Thus, you will also able to know the different aspects involved

incase of collection of book debts, dividend received, sale of investment, goods sold on hire purchase system and insurance premium in the process of vouching.

6.3 MEANING OF VOUCHING

Vouching is an act of examining documentary evidence by which the accuracy and authenticity of book entries can be ascertained. It is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substaining a transaction. In simple words vouching is a careful examination of all original evidences i.e. invoices, statements of receipts, correspondence, minutes and contracts etc. with a view to ascertain the accuracy of the entries in the books of accounts and to make sure that no entries have been omitted in the books of accounts.

According to Dicksee, "Vouching consists of comparing entries in books of accounts with documentary evidence in support there of." It means the checking of the correctness and authenticity of the transactions. According to Sir Ronald Irish, "Vouching is a term which refers to the inspection by the auditor of the documentary evidence or vouchers supporting and substaining a transactions".

Common features of valid vouching:

1. The voucher must be written in the name of the party of the business.
2. The date, year and the amount must agree with the date, year and the amount entered in the books of accounts.
3. The description of the transaction given in the voucher and in the books of accounts must be the same.
4. The voucher must be passed "as in order' by same responsible person.
5. The voucher must be properly stamped with a revenue stamp in case of cash payment exceeding Rs. 5000.
6. If there is any change made in the voucher, are responsible person must affix his initial.
7. A voucher must not used for a previous transaction.
8. A voucher usually be in a printed form.



CHECK YOUR PROGRESS

Q 1: State any two features of vouching.

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6.4 VOUCHING OF CASH RECEIPTS



Blue Chip —
Extremely valuable

It has been accepted by the auditors that the vouching of cash receipts (debit side) of the cash book is more difficult than that of cash payment (credit side), since only indirect evidences are available i.e. counterfoils of receipts issued, carbon copies of receipts contracts and letters from the debtors confirming the balances of their accounts etc.

The auditor should consider the following points while vouching the 'Receipts Side' of the cash book.

(i) Examination of the Internal Check System : The auditor should be careful at the time of examination of internal check system in operation as regard cash receipts. In order to ascertain the efficacy of the system, he should test each portion of such check system in operation. If any discripancies are found, he should carry his examination further. If the examined transactions are in order, he is entitled to assume that the remainder can be safely passed.

If the system is inadequate in some respect the auditor should give special attention to those areas and vouch the transactions of there areas in detail.

(ii) Comparison of Cash Diary with Cash Book : Where a rough cash book or diary is kept, it should be properly compare with the cash book. If the cash received intems are entered in the diary by misappropriated by the cashier and not entered in the cash book, the auditor must detect this fraud by proper examination of records. If he fails, he might be held responsible. Non-examination of memorandum books like Cash Diary is considered as an act of negligence because the auditor is required to examine the records beyond the books of accounts also if necessary. It proves the truth of a matter.

(iii) Checking the counterfoils of bank pay-in-slip book with the debit side of cash book : The auditor should also check the counterfoils of bank book with the debit side of the cash book and note particularly that the total deposit in the bank as per the bank pay-in-slip in book is equal to the total of the receipts as per the cash book.

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

1. Opening Balance : This can be vouched by reference to the duty audited balance sheet of the previous year. This is done to verify that the actual balance has been brought forward.

2. Cash Sales : Opportunities for fraud under this head are many because the salesman may sell the articles and may not make the entry in the cash book. Therefore, the auditor should examine the effectiveness of the internal check system in operation in regard to cash sale. For this he should check the following :

(i) Checking of cash sales register : The auditor should check the cash sales register with the carbon copies of the cash memos.

(ii) Checking the summary of daily cash with cash book : The auditor should check the summery of daily cash and tally it with the receipts recorded in the cash book.

(iii) Checking the pay-in-slip : The total cash sales of the day is deposited in to bank on the next day and the auditor should check the counterfoils of pay-in-slip to ensure that cash sales are duly deposited in to the bank.

(iv) Checking the daily summaries : The auditor should check the daily summaries prepared by the salesman, cashier and gate keeper. If he does not check them he would be held responsible for any fraud remaining undetected.

(v) Checking the dates of cash memos and on cash book : The auditor should check the dates written on the cash memos and on the cash book where receipts of the day are recorded. If there is any difference, it should be properly enquired.

(vi) Checking the cancelled cash memos : The auditor should check the cancelled cash memos – original and carbon copies and should see that they are not detached.

(vii) Discount Policy : The auditor should enquire about the policy towards discount and any excessive discount should be enquired into.

(viii) Cash memos against credit sales : The auditor should discourage the system of issue of case memos against credit sales. It creats a problem of vouching the actual cash sales.

(ix) Checking sales with the stock register : The auditor should check a few items of sales with the stock register whether the sales are genuine or proper entries are made therein.

6.5 VOUCHING OF CASH PAYMENTS

The object of vouching the credit side of cash book is not only to ascertain that money has been paid also but to ensure that the payments have been made –

(a) to the proper and right party,
(b) on behalf of the business for a proper purpose,
(c) for the accounting period under audit,
(d) after proper authorisation,
(e) against a proper voucher, and
(f) correctly recorded in the books of accounts.

The auditor should carefully and intelligently examine the vouchers presented to him and see that all the vouchers are numbered serially and filled in order.

The following are some of the important and main items on the credit side of the cash book :

1. Payments of Capital Expenditure : Payments made for acquiring fixed assets are of the nature of capital expenditure. The auditor, have been property authorised and are properly capitalised. Some of the items of capital nature and duties of an auditor in each case are discussed bellow :

(a) Freehold and Leasehold Property and Buildings : The auditor should vouch this item with the help of the agreement for the purchase of property or the lease deed or conveyance and title deeds. If the property has been purchased through a broker, this statement of accounts should be examined to know the money paid. If the property has been purchased through auction, the accounts of the auctioneer should be vouched. He should see that the property has been registered in the name of the client according to the Transfer of Property Act. He should inspect the transfer deed and must obtain a certificate from the solicitors to this effect.

(b) Plant and Machinery : The auditor should examine invoices, receipts in respect of the payment made and other similar evidences giving full particulars of the transaction. He should make sure that the purchase of the items has been properly authorised. In the case of a machine, cost of carriage and cost of erection can be added to the invoice price.

(c) Patents : In case patents have been purchased, the auditor should examine the patents and receipts aknowledging the purchase consideration. If patents have been purchased through an agent, his commission should be capitalised. Agents commission can be vouched with the help of the agent accounts. Any expense incurred in acquiring it should be capitalized. Any payments made towards the renewal, fee should not be capitalized as it is a revenue expenditure. Where patents are received through research, the auditor should see that expenses incurred on experiment and research are capitalized.

(d) Investments : The auditor should vouch the payment made for the purchase of investment (shares and securities) with the 'Brokers Bought Note'. He should examine the investment physically. The auditor should see that dividend from such investment is received subsequently and the expenditure is properly allocated between capital and revenue. In case of new

issue, the letter of allotment and the banker's receipts for the investment have been made in accordance with the provisions of Companies Act. He should also see that the investments are registered in the name of the company required under Sec. 49 of the Companies Act.

(e) Loans : The auditor should examine documents concerning loan agreement and the receipt given by the borrower. This will enable him to know the terms and conditions of loan, the rate of interest and the date of repayment of the loan. In case loan has been advanced against certain securities, he should inspect such securities. If the loan has been advanced against mortgage, he should examine the receipts from the borrower, the mortgage deed and title deeds and other documents. In the case of loans to directors, the managing directors and other officers of a company, he must see that the provisions of the Companies Act are complied with.

2. Wages : In manufacturing business, vouching of payment of wages is of great importance. Therefore the vouching of this item requires special attention on the part of the auditor. There are many chances of fraudulent payment under this head. Before vouching the account of wages paid, the auditor should carefully examine the system of internal check in force in the business. He should also examine the system regarding the preparation of wage sheets and the system of payment of wages. If there is no satisfactory system in force or the system is bad and faulty, he should point out its chart coming to his client and should disown his responsibility for this item. In order to avoid misappropriation of case or errors in the wage sheets, the work should be done on the lines of time records, piece work records etc.

3. Travelling Allowance : The auditor should examine the rules and regulations regarding payment of travelling allowances. He should see that the travelling allowance bills have been duly checked and signed by a responsible officer in the light of approved rules and regulations.

4. **Bills Payable :** The auditor should check the concealed bills returned. Bank pass book and bills payable book can also be checked.
5. **Insurance Premium :** The auditor should examine the premium notice, the insurance company's receipts and the insurance policies. Details about the amount of premium payable, mode of payment and the date of maturity of the policy can be verified from the insurance policy.
6. **Freight and carriage :** The payment made on account of this item should be vouched with the statements rendered by the shippers or carrier together with the receipts. He should see that allowances in respect of rebates have been properly accounted for.
7. **Salaries :** The auditor should examine the salary register which contains details regarding the monthly salary and compulsory deductions in respect of each employee. He should compare the cheque drawn for payment of salaries with the 'Salary Register' and the variation if any should be looked into. He should also check the due date on which the increment of an employee falls due to avoid fictitious entry. He should make sure that the salaries to the employees have been paid after deductions in respect of Providend Fund, Income Tax, Contribution to Health Scheme and the advance or loan if any etc.
8. **Agents and Traveller's Commission :** The auditor should examine the agreement of the travellers and the agents to ascertain the terms and conditions of appointment and the rate of commission. Receipts signed by the agents or travellers must be vouched and compared with the cash book.
9. **Customs & Excise Duties :** The auditor should see that custom duties are paid on imported goods and excise duties are paid on domestically produced and consumed goods.

   Custom duty is normally paid through clearing agents and the auditor should vouch the payment with the agents bill and received 'Bill of Entry'. He should see the calculations and see that only the actual amount is paid. If it is paid for raw materials or spare parts, it is to be debited to the respective account and if it is paid fixed asset, it should be debited to the asset account concerned.

Excise duty is to be checked with the copy of receipt Challan which shows the payment. If the Challan is not available the auditor should check the 'Issue Permit' granted by the controller and compare the payment with the issue permit.

10 **Rents payable :** The agreement with the landlords and receipt from them should be examined.

11. **Payment to Creditors :** Payment made to the creditors should be vouched by the auditor as follows :

(a) To compare the payment with the receipts issued by the creditor acknowledging the receipt of money.

(b) To compare the money due to the creditors with the accounts of the creditors and the actual invoices received from there.

(c) To enquire whether or not periodical statements have been received from the creditors and if received they should be comparedwith the creditors accounts.

(d) To refer the minutes, contracts and other evidences available.

(e) To enquire in to the difference between the amount of invoice and the account actually paid to see that excess payment made, if any, is realised or adjusted subsequently.

(f) To see that trade discount has been deducted from the purchases so as to arrive at the net amount payable.

12. **Petty Cash :** The auditor should examine the system of internal check in respect of petty cash. He should see that petty cash book must be kept upon the imprest system. In case the system is unsatisfactory he should disown any responsibility to the client. Cash can be misappropriated easily as there are no vouchers for a member of petty payments. He should vouch the cheques drawn for petty cash through referring the cash book. He should also check, cross check and balance the petty cash. Maintenance of vouchers should be insisted upon for all payments above Rs.2 or 40. In those cases where it is impossible to obtain receipts, petty cash vouchers should be made out giving details of expenditure. Such vouchers should be signed by the person actually spending the money and counter signed by the responsible officer of the organisation.

13. Bank Account : Now-a-days settlement of payment between the parties is done through banks. Therefore the vouching of this item is very important otherwise there can be manipulation in account. In a business, cash or cheques are sent to the bank for deposit or collection as well as money is withdrawn from the banks. The auditor should check the receipts and deposits in the following ways :

1. Payment in to the bank :

(a) He should compare the cash book with the bank pass book.

(b) Payment in to the bank should be vouched with the counterfoils of the paying-in-book.

(c) Direct payment in the bank should be vouched from bank's advice notes.

(d) Bank's interest in the deposits should be vouched from the banks advice notes.

(e) Auditor should carefully note the dates of different transaction.

2. Payment out of the Bank :

(a) Auditor should compare the cash book with the pass book.

(b) Payment out of the bank can be vouched with the counterfoils of the cheques issued.

(c) Direct payment by the bank to the society, club or association as subscription as per the instruction of the client should be vouched from the advice note of the banker for such a transfer and payee's receipt.

(d) Bank charges can be vouched from the bank's advice note.

(e) Auditor should carefully note the dates. Bank reconciliation statement is also prepared to verify the balance at bank. The auditor should ascertain the bank balances from the bank directly to confirm the balances.

14. Directors Fee : Director of a company are not entitled to get any monthly salary. However, directors of a company can claim any remuneration for attending the board meeting. In that case the auditor should examine the articles of association to know whether directors can be paid for attending such meeting or not. He should also find out

from the articles of association about the amount of fee payable to the directors for attending the board meeting. He should also examine the minute books and Director's Attendance Register to know the number of meeting attended by them in order to find out the amount payable to directors. He should examine the voucher in this behalf.

15. **Postage :**The auditor should verify the postage register. He should compare the postage register with the cash book and the balance of stamps in hand should be counted. Where the franking machine is used by the office the receipt issued by the post office for the payment should be examined.

6.6 COLLECTION OF BOOK DEBTS

Amount received from debtors should be vouched with reference to counterfoils of the receipts book, bank pay-in-slips, discount allowed, bad debts written off and confirmatory statements of balance from the debtors, The auditor should pay attention to the following while vouching the item :

1. **Counterfoils of the Receipt Book :** The auditor should compare the cash receipts from debtors recorded on the receipts side of the cash book with the counterfoils of the receipts issued to them with special attention to the amounts and dates recorded in the counterfoils and the cash book. It is done in order to detect the following types of frauds where they are committed by the cashier.
   (a) Defalcation of cash either not writing at all or writing lesser amount in the cash book than the amount actually received as mentioned in the counterfoils of the receipt book.
   (b) Recording in the cash book on a later date than the date of actual receipt and misappropriating the money for a temporary period.
2. **Counterfoils of the pay-in-slips :** The auditor should also see the counterfoils of the bank pay-in-slips and compare them with the amounts recorded in the cash book in respect of cash and cheque received. Special attention should be given to the dates recorded in the cash book and counterfoils of the pay-in-slips.

3. **Discount Allowed :** The auditor should pay special attention to the discount allowed usually a discount is allowed by a responsible officer at a fixed date. The auditor should vouch discount with the declared policy of discount of the concern. If there is any special discount, it should be properly enquired into. He should take care about fictitious discount, which may be shown in the discount column of the cash book by recording lesser amount of cash than the actually received from the customer. This can be detected by comparing the counterfoils of the receipt book and the cash book.
4. **Bad Debts Written off :** Bad debts should be vouched with reference to the authority and correspondence between the client and the customer. Only a responsible officer should write off a debt as bad. Sometimes a dishonest clerk may write off the whole or a part of debts as bad debt after receiving the whole amount. So the auditor should verify the correspondences and the authority of doing so.
5. **Confirmatory Statement From Debtors :** Wherever possible, after taking permission from the client, the auditor should send to the debtor a statement of account and ask him to confirm the balance as shown in the statement. The auditor should request the debtor to send the letter of confirmation direct to the auditor so that the auditor can detect any fraud committed by the cashier.



CHECK YOUR PROGRESS

Q 2: What are the different aspects an auditor should pay attention while vouching an item for the amount received from debtors ?

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6.7 DIVIDEND RECEIVED

Dividend received is to be vouched with the counterfoils of the tops of the dividend warrants or the letters covering the cheque can also be checked with the tax deduction certificate. If dividend warrants are deposited with the bank for collection, bank pass book must be referred to.

Where shares are sold or purchased the auditor should refer to the broker's sold note and purchase note. He should also see that dividend has been received subsequently and has been credited to the dividend account.

The auditor should also refer to the annual reports of all the companies whose shares are held by his client so as to see the dividend and the rates.

6.8 SALE OF INVESTMENT

The auditor should see the following paints :

1. **Vouching with broker's sold note and bank advice :** The amount received on sale of investments should be vouched with the broker's sold note. If the investment are sold through bank, the bank advice should be examined to know the details.
2. **Vouching of profit or loss :** The auditor should see that profit or loss on sale of investments is correctly ascertained and properly recorded.
3. **Vouching of dividend in case of ex-dividend dale :** When investments have been sold Ex-dividend, the auditor should see that dividend has been received subsequently.
4. **Vouching the profit of loss or earmarked fund investments :** Where investments relate to some earmarked funds, the profit or loss on sale of investment should also be transferred to that earmarked fund account.

6.9 GOODS SOLD ON HIRE PURCHASE SYSTEM

The auditor should inspect the hire purchase agreement in order to ascertain the amount of instalment, total number of instalments, the rate of interest and other terms and conditions. He should also see that the whole

amount of instalment should not be credited to sales account. He should see the proper allocation of instalment between sales account and interest account.

In case of outstanding instalments, the auditor should see the correspondence between the client and the hire purchaser.

6.10 INSURANCE PREMIUM

The auditor should see the following points :

1. **Insurance Policy and the Receipt :** In case of a new policy the auditor should examine the policy document or cover note and the premium receipt and check the same with cash book entry.
2. **Renewal Receipt :** In case of a renewal policy, the auditor should see the renewal receipt.
3. **List of Polices :** Where there are a large number of policies, the auditor should ask for a list of policies and examine them in respect of the subject matter of insurance, sum insured, date of maturity, amount of premium etc. The auditor should see that the total amount of premium paid on the policies tally with the cash book entry.
4. **Lapsed Policies :** In case of lapsed policies, the auditor should enquire in the reason thereof.
5. **Unexpired Premium :** The auditor should see whether adjustment has been made for the unexpired portion of the premium.
6. **Under insurance :** Incase of under insurance the auditor should refer it to the management.



6.11 LET US SUM UP

In this unit, we have discussed the following aspects:

- Voucher is the documentary proof of tarnsactions recorded in the books of account.
- Vouching is the examination of documentary evidence to ensure the accuracy and authenticity of the books of account.

- Voucher must be in writing.
- Vouching of cash receipts and cash payments.
- Vouching of the amounts of money collected from debtors, bad debts written off.
- Vouching of dividend received, sale of investment etc.



6.12 FURTHER READINGS

1) Kumar R. & Sharma V. (2005). *Auditing : Principles and practice.* New Delhi, Prentice Hall of India Pvt. Ltd.

2) Tandon B.N., Sudharsanam S. & Sundhprabha S. (2010). *A handbook of practical auditing*. New Delhi, S. Chand & Co. Ltd.

6.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: (i) The voucher must be written in the name of the party; (ii) The date, year and the amount must agree with the date, year and the amount entered in the books of accounts.

Ans to Q No 2: The following are the different aspects an auditor should pay attention while vouching an item for the amount received from debtors :

i) Counterfoils of the Receipt Book

ii) Counterfoils of the pay-in-slips

iii) Confirmatory Statement From Debtors

iv) Bad Debts Written off

v) Discount Allowed.



6.14 MODEL QUESTIONS

Q 1: What do you mean by vouching?

Q 2: What are the factors an auditor should pay attention while vouching of cash receipts?

Q 3: What are the factors an auditor should payattention while vouching of cash payments?

Q 4: What are the important factors an auditor should see while vouching an item?

Q 5: How an auditor vouch the amount received for sale on investment?

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UNIT 7: VERIFICATION OF ASSETS

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Verification of Assets

7.4 Objectives of Verification of Assets

7.5 Distinction between Vouching and Verification

7.6 Valuation of Assets

7.7 Methods of Valuation of Assets

7.8 Distinction between Verification and Valuation

7.9 Verification and Valuation of Different Kinds of Assets

7.10 Let Us Sum Up

7.11 Further Readings

7.12 Answer to Check Your Progress

7.13 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning and necessity of verification of assets
- explain the objects of verification of assets
- describe the meaning, methods and factors of valuation of assets.
- discuss the audit procedure for verification and valuation of different kinds of assets
- explain the meaning of and objects of verification of liabilities and valutation of different kinds of liabilities.

7.2 INTRODUCTION

In this unit, we have tried to acquint you with the subject matter "verification of assets" as properly as possible. First you will get an idea about the meaning of verification of assets. The discussion also includes about the meaning and methods of valuation of assets. Than you will also

able to know the distinction between the vouching and verification, verification and valuation of assets. Lastly you will know about the verification and valuation of different kinds of assets.

7.3 VERIFICATION OF ASSETS

The word verification means 'proving the truth' or 'confirmation. In auditing, verification means substantiating the existence and value of the items appearing in the Balance Sheet.

One of the important duties of an auditor is to verify the assets and liabilities appearing in the balance sheet. The auditor must satisfy himself about the existence of the assets and confirm that it can be written in the balance sheet of the company.

Verification is a process by which an auditor satisfies himself by actual inspection about the existence of assets ownership, possession, valuation of the various items appearing in the balance sheet.



CHECK YOUR PROGRESS

Q 1: What do you mean by verification of assets?

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7.4 OBJECTIVES OF VERIFICATION OF ASSETS

Verification of assets is the process, which is adopted by the auditor to satisfy himself with regards to the following objectives :

i) the existence of the assets,

ii) the assets belongs to the client,

iii) they are in possession of the client,

iv) the valuation of assets,

v) the encumbrances on the assets, and

vi) the proper classification and recording of the assets

The "Statement of Auditing Practices" issued by the Institute of Chartered Accountants of India, has laid down that verification of assets should be aimed at establishing their -

i) Existence - By physical examination of the assets or by documentary evidence.

ii) Ownership - By examining title fees, legal or other official documents

iii) Possession - By examining the physical control of the assets.

iv) Adequate disclosure of encumbrances By checking the documentary evidence relating to pledging hypothecation etc, if any.

v) Proper Recording - By examining the books of accounts and comparing the book values with balance sheet values.

vi) Proper valuation - By examining whether the generally accepted accounting principles have been properly followed or not.

7.5 DISTINCTION BETWEEN VOUCHING AND VERIFICATION

Both vouching and verification relates to the examination of books of accounts or documentary evidence in support of existence of assets appears in the balance sheet. However, they can be distinguished on the basis of following points :

POINTS	VOUCHING	VERIFICATION
1. Object	The object of vouching is to test the truthfulness of a transaction	The object is to examine the existence of an asset or a liability appearing in the balance sheet.
2. Value recoded	By vouching auditor is to see that the amount recorded in the books are those actually paid or received as per vouchers and other documents.	By verification, auditor is to see that the values assigned to various assets are proper following the principles of generally accepted accounting principles.
3. Owner-ship and possession	Vouching test the ownership and possession of the assets at the time of occurrence of the transaction.	Verification test the existence and possession of the assets at the balance sheet date.

POINTS	VOUCHING	VERIFICATION
4. Scope	Vouching is the detailed cheeking of records to as-certain the authenticity of a transaction	Verification includes not only the cheeking of records but also physical examination and valu-ation of assets.
5. Pre-sentation	Vouching is testing the recording of the transactions in the books of accounts.	Verification is examining the presentation of the recorded assets and liabilities in the balance sheet.
6. State of Assets and liabilities	Vouching tests the state of the assets on the day of acquisition but does not indicate the subsequent state of affairs as regards assets. It examines the incidents taking place on a particular point of time.	Verification tests the condition of The assets As regards ownership, possession, existence encumbrance etc since the date of acquisition to the date of balance sheet. It examiner all the incidence taking place during a particular period.



CHECK YOUR PROGRESS

Q 2: : Mention two distinctions between vouching and vertification ?

i) .....

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ii) .....

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7.6 VALUATION OF ASSETS

Valuation of assets is an important part of verification of the assets. It is important as it affects the accuracy of the balance sheet and profits of a concern. Valuation of assets means to test the actual value of an asset.

The auditor is not a valuer because he may not possess the required technical knowledge for the purpose. So, he has to depend on the opinion of the officials and experts for the purpose of valuation assets.

7.7 METHODS OF VALUATION OF AN ASSETS

An asset may be valued at any of the following methods :

i) **Cost Price :** It is the price paid for acquiring an asset including freight, insurance, installation charges etc.

ii) **Market Value :** If is the value which is expected to be received by sale of the asset.

iii) **Replacement Value :** It is the value which will be required to be paid for purchase of the same type of asset to replace the existing asset. It include all incidental expenses.

iv) **Book value :** It is the value of an asset which is shown in the books of accounts of the concern. Usually book value is the cost less depreciation written off.

v) **Realisable value :** It is the value which may be releasible if the asset is sold in the market. Incidental charges such as commission etc are to be deducted from the selling price.

vi) **Going concern value :** It is the conventional or historical value of an asset. In this method assets are valued at cost less depreciation to date.

Factors to be considered for valuation of asset :

For valuation of assets the auditor should keep in mind the following factors:

i) Original cost of the asset.

ii) Expected life of the asset.

iii) Scrape value of the asset.

iv) The chances of the asset becoming obsolete.

v) The method of depreciation adopted.

vi) The replacement value of the assets.

7.8 DISTINCTION BETWEEN VERIFICATION AND VALUATION

Both verification and valuation are necessary for the purpose of ascertaining true and fair view of the state of affairs and the results as shown in the financial statements. However, there are some differences in between the two. These are :

Points	Verification	Valuation
1. Scope	Verification includes ascertaining existence, ownership, possession, valuation and proper disclosure of an asset.	Valuation relates only to the examination of the accuracy and propriety of value of various assets.It is a part of verification.
2. Object	The object of verification by an auditor is to satisfy himself with regard to existence, ownership, possession and valuation of an asset.	The object of valuation of assets is to value the assets according to generally accepted accounting principles.
3 . Responsibility	Proper verification of the asset is one of the duty of the auditor and he may be held guilty of negligence in case of improper verification of assets.	Auditors are expected to be the valuer. Valuation is done by the management and the auditor can rely on a certificate issued by an authorised valuer for valuation of assets.

7.9 VERIFICATION AND VALUATION OF DIFFERENT KINDS OF ASSETS

Cash in Hand :

i) The auditor should physically certify the cash on the last day of financial period. But If this is not possible, the auditor should verify physically on a surprise basis at any time near the close of the year. The auditor may also carries out surprise verification of cash during the year

ii) At the time of physical verification of cash, all cash balances such as, petty cash, balance of staff welfare fund etc should be verified.

iii) Explanations should be obtained from the management in case of IOU (I owe you) or other similar documents are found during physical verification. Such IOU'S should be disclosed as short term advance in the balance sheet.

iv) If the organisation is consistently maintaining unduly large balance of cash in hand, explanations are sought from the management

regarding the need for maintaining such balance and should carry out surprise verification of cash more frequently during the year.

v) If there is any difference between the actual cash balance and cash balance as per cash book, the auditor should seeks explanations from the management.

Cash at bank : The auditor usually carries out verification of cash at bank as follows :

i) The auditor should confirm the cash at bank of all types of accounts including in operative accounts directly with the bank. For this, he should request the concern to ask its banks to send confirmation of the balances directly to the auditor.

ii) Examine the bank reconciliation statement prepared as at the end of the accounting period. The auditor should particularly examines that the post dated cheques both received or issued are not accounted for in the books of accounts. The auditor should also examine those items which are outstanding for an unduly long period.

iii) Examine fixed deposit receipts and other receipts and documents for verifying fixed deposits.

iv) Examine remittances in transit with reference to their credit in the bank account in the subsequent period.

v) If the bank statements reveals that large number of cheques have issued or deposited in bank account around the close of the accounting period, the auditor should examine the bank statements of subsequent period to ensure that entries relating to such cheques have not been reversed.

vi) In case of state cheques, the auditor should ensure that suitable adjustments have been made in the books of a accounts.

vii) Review the total number of bank accounts maintained by the entity to ensure that there are no imperative accounts through which grand is possible.

Stock in trade (Inventories) : Inventories are the tangible items which are held by a business for sale or use in production of goods and services. It

generally consist of raw materials including components, work in progress, finished product, by product and materials such as maintenance suppliers, stores spare parts and loose look to be used indirectly in production or related activities. The management has the responsibility for proper determination of the quantity and value of inventories.

Audit procedures to be followed to verify existence, ownership and possession :

i) Examine stock records with reference to relevant documentary evidence such as receiving report, material issue notes, inspection reports etc.

ii) Count the inventory physically.

   a) Inspect count instructions given to the staff of the management.

   b) Review the procedures to account for movement of inventories.

   c) Review the cut off procedures.

   d) Review procedures for identifying defective, damaged.

iii) Inspect original verification sheets for inventory.

iv) Enquire about stock held by third parties and lien.

To verify valuation and Disclosure :

i) Ensure that valuation method used is in accordance with AS-2.

ii) Inspect supporting records relating to unit cost data

iii) Examine treatment of overheads

iv) Ascertain the stage of completion of work in progress.

v) Examine disclosure relating to inventory.

Investments : Investment means investment in the form of shares, stocks, dedentures and other semities including Govt. bonds. For verification of investment, an auditor may employ the following procedues: For verification of existence, ownership and possessiob :

i) Inspect whether the investment made are within the authority of the entity.

ii) Inspect the investment register with reference to relevant documents.

iii) Carry out a physical examination of the securities.

iv) Examine statements and certificates issued by depository or custodian for the scripts held by them.

v) Obtain certificates from third parties if they hold investment owned by the client.

vi) Examine justification for keeping investments with third parties other than banks.

vii) Ascertain the reasous for holding investment otherwise than in the name of the entity.

To verify valuation and disclosure :

i) Compare valuation practices against these prescribed by recognised accounting principles (AS-13) specially with regards to determination of cost of investment, classification of investment into long term which are to be valued at cost and short term investment which are to be valued at cost or fair value whichever is lower.

ii) Examine whether investments have been disclosed in the balance sheet according to accounting principles and relevant statutory requirements, if any.

Book Debts (Sundry Debtors) : The auditor should undertake the following procedure for verification of book debts :

To verify existence, ownership and possession :

i) Obtain a schedule of debtors duly signed by a responsible officer and examine the schedule with individual account of debtors.

ii) Inspect the relevant documents such as invoice, transporting receipts, credit memo's etc for each debtors.

iii) Vouch collection of accounts receivable subsequent to balance sheet date.

iv) Examine the realisability of debts as at the date of balance sheet.

v) Re compute the provision for bad and doubtful debts and compare it with past period.

vi) Examine the relevant correspondence for bad debts written off with the debtor concern.

vii) Examine memorandum record for subsequent recovery of bad debts.

To verify Valuation and Disclosure : Ascertain whether debtors have been properly classified and disclosed in the balance sheet in accordance with accounting principles and statutory requirements if any.

Bills Receivable : The auditor should examine the internal control system with regard to bills receivable and following procedure may be adopted to verify bills receivable.

i) Verify the opening balance of bills receivable with the last years audited balance sheet.

ii) Count and compare the bills receivable with Bills Receivable Account or impersonal Ledger.

iii) Verify the bills receivable on hand at the end of the year and ensure that these are properly drawn, stamped and accepted.

iv) In case of discounted bills, these should be verified with the confirmation obtained from the bank and entries in the cash book.

v) In case of dishonoured bill, he should ensure that adequate provision has been made for irrecoverable amount.

vi) Ensure that bills which have been matured but the amount has not been received, have been renewed subsequently.

Freehold property : A freehold property has two characteristic viz immobility and indeterminate duration such as land and building held in the name of the owner. The auditor should follow the following procedure for verification of freehold land and building.

Verification to ascertain the existence and ownership :

i) Verify the existence and ownership of land by inspection of the original title deeds and conference or purchase deed which should be in the name of the client.

ii) For purchase of freehold land during the year, the contract with the vendor, approval of appropriate authority, assessment notice and all correspondence regarding this should be examined.

iii) For sale during the year, approval of appropriate authority, brokers note a auctioneer's note or a statement showing quotations invited from prospective seller, sale deed, bank pass book should be examined.

To assenting the possession and determine liens if any :

i) The title deed should be in the custody of owners. In case of mortgage title deed would be in the possession of the mortgage or solicitors.

The auditor should obtain a certificate from mortgage or his lawyer confirming it.

ii) The auditor should determine whether the land in free from any charge or encumbrances.

To examine valuation and disclosure :

a) Land is a non depreciable asset. It is generally shown at historical cost which includes purchase price. broker's commission, stamp duties, registration fees, legal charges and also development expenses.

b) Building is a depreciable asset. Therefore, the auditor should see that proper depreciation is charged against it.

c) If land and building were purchased as a package, the auditor should ascertains accounting their values separately.

d) If land and building were demolished, the whole amount including the cost of demolition should be capitalised.



7.10 LET US SUM UP

In this unit, we have discussed the following aspects :

- Verification means 'proving the truth' or 'confirmation'.
- The object of vouching is to test the truthfulness of a transaction.
- Valuation of assets means to test the actual value of assets
- Realisable value means value of the asset after it sold.
- Market value means the value expected to be received by sale of assets.



7.11 FURTHER READINGS

1) Basu S. K. (2008). Auditing : Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005). Contemporary Auditing. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001), Principles and practice of Auditing, New Delhi, Himalaya Publishing House.



7.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Verification means substantiating the existence and value of the items appearing in the balance sheet.

Ans to Q No 2: The two distinctions between vouching and verification are-

i) Vouching is testing the recording of the transactions in the books of account. But, verification is the examining the presentation of the recorded assets and liabilities in the balance sheet.

ii) The object of vouching is to test the truthfulness of a transaction whwreas the object of verification is to examine the existence of an assets or a liability appearing in the balance sheet.



7.13 MODEL QUESTIONS

Q 1: What do you mean by vouching ?

Q 2: What do you mean by verfication of assets ?

Q 3: What are the distinctions between vouching and verification ?

Q 4: What are the different methods of valuation of assets ?

Q 5: What are the different methods of valuation of assets ?

Q 6: What are the distinctions between valuation and verification ?

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UNIT 8: VERIFICATION OF LIABILITIES

UNIT STRUCTURE

8.1 Learning Objectives

8.2 Introduction

8.3 Meaning of Verification of Liabilities

8.4 Objectives of Verification of Liabilities

8.5 Procedure of verification of liabilities

8.6 Verification of Loans and Borrowings

8.7 Verification of Trade Creditors

8.8 Verification of Bills Payable

8.9 Verification of Different Kinds of Provisions

- 8.9.1 Provisions for Taxes and Duties
- 8.9.2 Provisions for Gratuity
- 8.9.3 Provisions for Dividends

8.10 Examination of Disclosure of liabilities in Financial Statements

8.11 Let Us Sum Up

8.12 Further Readings

8.13 Answer to Check Your Progress

8.14 Model Questions

8.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning of verification of liabilities
- explain the objectives of verification of liabilities
- discuss the procedure for verification of liabilities
- discuss the audit procedure for verification of different kinds of liabilities

8.2 INTRODUCTION

In this unit, we shall discuss the audit procedure regarding the "verification of liabilities" as properly as possible. We shall begin with the meaning and objectives of verification of liabilities and further continue our discussion regarding the verification of different kinds liabilities.

8.3 MEANING OF VERIFICATION OF LIABILITIES

Liabilities are the financial obligations of an enterprise other than owner's funds. It includes borrowings, loans, trade payables and other current liabilities, deferred payment credits and provisions. Verification of liabilities is the process of substantiation of liabilities recorded in the books of accounts by examination of legal and other documents and forming an expert opinion as to the existence, obligation, completeness, valuation and disclosure of liabilities of an entity. Verification of liabilities is as important as that of assets, because if any liability is omitted/understated/overstated, the Balance Sheet won't show a true and fair view of the financial position of the company. While verifying the liabilities of an entity, an auditor is required to have knowledge of applicable Accounting Standards. The auditor is also required to examine the proper disclosure of various liabilities in the Balance Sheet and Statement of Profit and Loss.

8.4 OBJECTIVES OF VERIFICATION OF LIABILITIES

Verification of liabilities is also as important as verification of assets. If the liabilities are not properly verified and valued, the balance sheet shall not reveal true and fair view of the state of affairs. Again, the profit and loss account will also be incorrect if liabilities are not properly accounted for. The objects of verification of liabilities are as follows :

i) **Existence :** Liabilities appears in the balance sheet are actually payable.

ii) **Obligation :** Liabilities represent obligation business to third parties.

iii) **Complete records :** All known liabilities must be properly accounted for and contingent liabilities should be shown as a footnote to the balance sheet.

iv) **Valuation :** Liabilities are shown in the financial statements with fair and reasonable amounts.

v) **Disclosure :** Accounting principles and other statutory provision should be followed for classification and disclosure of liabilities in the financial statements.



CHECK YOUR PROGRESS

Q 1: State the meaning of verification of liabilities.

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Q 2: Mention two objectives of verification of liabilities.

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8.5 PROCEDURE OF VERIFICATION OF LIABILITIES

Verification of liabilities may be carried out by employing the following procedures:

(a) examination of records;

(b) examination of disclosures;

(c) direct confirmation procedure;

(d) analytical review procedures;

(e) obtaining management representations.

The nature, timing and extent of substantive procedures to be performed is, however, a matter of professional judgement of the auditor which is based, inter alia, on the auditor's evaluation of the effectiveness of the related internal controls. While proceeding for the verification process, the auditor should examine that:

(a) All the liabilities have been clearly recorded on the Balance Sheet.

(b) All these liabilities are related to the business.

(c) The liabilities are all correct and duly authorised.

(d) They are shown in the Balance Sheet at their actual figures.

The auditor must verify at the close of the year that the liabilities stated in the Balance Sheet are in fact payable and all its liabilities that could be traced by the exercise of the diligence and care on the part of the auditor have been accounted for. He must also obtain a certificate from a responsible official stating that to the best of his knowledge and belief, all liabilities, whether for purchases (supplies) or expenses or any other account existing at the date of the Balance Sheet have been included in the books of account; also

that all the contingent liabilities have been disclosed in footnote to the Balance Sheet have been provided for.



CHECK YOUR PROGRESS

Q 2: : Mention two distinctions between vouching and vertification ?

i) .....

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ii) .....

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8.6 VERIFICATION OF LOANS & BORROWINGS

The auditor should examine that the loans obtained are within the borrowing powers of the entity. He should further examine the records to judge the validity and accuracy of the loans.

The auditor should verify that the book balances of loans and advances from banks, financial institutions etc. agree with the statement of the lenders.

The auditor should examine whether the directives issued by the RBI or any other appropriate authority regarding accepted deposits are complied with.

The auditor should verify whether the loans have been properly classified as short term and long term loans.

The auditor should go through the important terms and conditions in loan agreements and documents, examining any charges are created in respect of such loans and advances. He should examine whether the requirements of the applicable statute regarding creation and registration of charges have been complied with, if any.

In case the value of security falls below the amount of the loan outstanding, the auditor should examine whether the loan is classified as secured only to the extent of the market value of the security.

The auditor should ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made

8.7 VERIFICATION OF TRADE CREDITORS

The audit proceduce for verification of trade creditors are as follows:

i) The auditor should obtain a schedule of creditors and check it with purchase ledger. While examining the creditors accounts, the auditor should see whether the adjustments such as rebates, discounts, returns etc. are adjusted.

ii) Examine the documents relating to purchases such as invoices, receiving reports, credit notes, purchase book, purchase returns book etc.

iii) Examine the payments to the trade creditors.

iv) The auditors may obtain a confirmation of the amount due from the creditors on the balance sheet date or any other date as he thinks fit.

v) The auditor should ensure that the creditors have been disclosed properly as per the accounting principles and relevant statutory requirements.

8.8 VERIFICATION OF BILLS PAYABLE

The audit procedure for verification of bills payable are as follows :

i) The auditor should verify the bills payable with bills payable book and bills payable account.

ii) The auditor should check the bills payable already paid with the cash book and examine the returned bills payable.

iii) Examine the genuineness of the bills payable on the balance sheet date. The auditor should check the cash book of the next period as to whether any payment has been made in respect of such bills. He may also ask for confirmation from the drawer of the bills. If any charge has been created on any asset by accepting a bill the fact should be disclosed in the balance sheet.

8.9 VERIFICATION OF DIFFERENT KINDS OF PROVISIONS

The term 'provision' means amounts set aside for the probable, but uncertain, economic obligations of an enterprise. Audit of provisions basically

take into account examining the reasonableness and adequacy of the amounts provided for. The auditor is required to check whether the amount of provisions made are not in excess of what is reasonably required. Further, in determining whether a provision is required, the auditor should, among other procedures, make appropriate inquiries of management, review minutes of the meetings of the board of directors and correspondence with the entity's lawyers, and obtain appropriate management representations.

8.9.1 Provisions for Taxes and Duties

The auditor should examine the adequacy of provision for taxation after reviewing overall outstanding liability of the entity as at the date of Balance Sheet. The auditor should ensure that suitable adjustments have been made in respect of assessments completed, revised or rectified during the year. In case of any tax liability which has become payable and for which no provision has been made in the accounts, the auditor should qualify his report in such a situation. In case of a disputed tax liability, the auditor should see if adequate provision or suitable disclosure is made.

8.9.2 Provisions for Gratuity

While verifying provision for gratuity, the auditor should examine whether the entity is required to pay gratuity to its employees under Payment of Gratuity Act, 1972. The auditor should ascertain that adequate provision for accruing gratuity liability has been made by the entity. The adequacy of the gratuity provision should be certified by an actuarial. And if no such actuarial certificate is obtained by the entity, then the method of calculating the accruing gratuity liability should be examined by the auditor.

8.9.3 Provisions for Dividends

The auditor should examine the applicable provisions of relevant laws, relevant agreements and resolutions regarding provisions for dividends to be made by the entity.

8.10 EXAMINATION OF DISCLOSURE OF LIABILITIES IN FINANCIAL STATEMENTS

The liability of an entity needs to be disclosed properly in the financial statements. Certain relevant statutes lay down disclosure requirements in this behalf. The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements and wherever necessary, disclosure requirements of relevant statutes have been complied with.

In cases of loans which are guaranteed by third parties in whose favour the assets of the entity are charged, the auditor should examine whether the disclosures concerning such loans are appropriate. For example, they may be classified as secured with disclosure of the fact that the assets of the entity have been charged in favour of third parties which, in turn, have given guarantees to parties from whom loans have been obtained.

The auditor should recommend to the entity to disclose, in parentheses or in footnotes, the installments of term loans, if any, falling due for repayment within the next twelve months.

From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29.The auditor should examine that the following have been disclosed in respect of contingent liabilities:

(a) nature of each contingent liability;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect or a statement that such estimate cannot be made.



CHECK YOUR PROGRESS

Q 3: List the various procedures for verification of liabilities.

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Q 4: List the procedure for verification of Bills Payable.

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8.11 LET US SUM UP

In this unit we have discussed the following points:

- Verification of liabilities is the process of substantiation of liabilities recorded in the books of accounts by examination of legal and other documents and forming an expert opinion as to the existence, obligation, completeness, valuation and disclosure of liabilities of an entity.
- Verification of liabilities is as important as that of assets, because if any liability is omitted/understated/overstated, the Balance Sheet won't show a true and fair view of the financial position of the company.
- The objectives of verification of liabilities are:
  1. Existence
  2. Obligation
  3. Complete records
  4. Valuation
  5. Disclosure
- Verification of liabilities may be carried out by employing the following procedures:
  a) examination of records;
  b) examination of disclosures;
  c) direct confirmation procedure;
  d) analytical review procedures;
  e) obtaining management representations.
- Audit of provisions basically take into account examining the reasonableness and adequacy of the amounts provided for.
- The auditor should examine the adequacy of provision for taxation after reviewing overall outstanding liability of the entity as at the date of Balance Sheet.
- While verifying provision for gratuity, the auditor should examine whether the entity is required to pay gratuity to its employees under Payment of Gratuity Act, 1972.

- The auditor should satisfy himself that the liabilities have been disclosed properly in the financial statements and wherever necessary, disclosure requirements of relevant statutes have been complied with.



8.12 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). Principles and practice of Auditing, New Delhi, Himalaya Publishing House.

4) ICAI (2016). Advanced Auditing and Professional Ethics, Study Material, ICAI, New Delhi.

8.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Verification of liabilities is the process of substantiation of liabilities recorded in the books of accounts by examination of legal and other documents and forming an expert opinion as to the existence, obligation, completeness, valuation and disclosure of liabilities of an entity

Ans to Q No 2: Two objectives of verification of liabilities are as follows :

i) **Existence :** Liabilities appears in the balance sheet are actually payable.

ii) **Obligation :** Liabilities represent obligation business to third parties.

Ans to Q No 3: Verification of liabilities may be carried out by employing the following procedures:

(f) examination of records;

(g) examination of disclosures;

(h) direct confirmation procedure;

(i) analytical review procedures;

(j) obtaining management representations.

Ans to Q No 4: The audit procedure for verification of bills payable are as follows :

i) The auditor should verify the bills payable with bills payable book and bills payable account.

ii) The auditor should check the bills payable already paid with the cash book and examine the returned bills payable.

iii) Examine the genuineness of the bills payable on the balance sheet date. The auditor should check the cash book of the next period as to whether any payment has been made in respect of such bills. He may also ask for confirmation from the drawer of the bills. If any charge has been created on any asset by accepting a bill the fact should be disclosed in the balance sheet.



7.13 MODEL QUESTIONS

Q 1: What do you mean by verification of liabilities? State the objectives of verification of liabilities.

Q 2: Write a note on verification of:

a) Loans and Borrowings

b) Trade Creditors

c) Bills Payable

d) Provision for taxes and duties

e) Provision for gratuity

f) Provision for Dividend

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UNIT 9 : INVESTIGATION

UNIT STRUCTURE

9.1 Learning Objectives

9.2 Introduction

9.3 Meaning of Investigation

9.4 Definitions of Investigation

9.5 Features of Investigation

9.6 Objectives of Investigation

9.7 Purpose for Investigation

9.8 Distinction between Audit and Investigation

9.9 Essentials of an Investigation

9.10 Duties of an Investigator

9.11 Liabilities of an Investigator

9.12 General Approach for Investigation under various cases

- 9.12.1 Investigation on behalf of a person or company who intends to purchase a running business
- 9.12.2 Investigation on behalf of a client who wishes to invest in the capital
- 9.12.3 Procedure of an Investigation under Companies Act, 2013
- 9.12.4 Investigation on behalf of the proprietor seeking to know the causes for the abnormal fluctuations in profits
- 9.12.5 Investigation on behalf of a person who is interested to join a partnership firm as a partner
- 9.12.6 Investigation on behalf of a bank or any other person who wants to lend money to a business and is interested to know its financial position
- 9.12.7 Investigation in case the proprietor of the business suspected fraud

9.13 Let Us Sum Up

9.14 Further Readings

9.15 Answers to Check Your Progress

9.16 Model Questions

9.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- explain the meaning of investigation
- discuss the features, objectives and purpose of investigation
- distinguish between audit and investigation
- discuss the duties and liabilities of an investigator
- discuss the procedure of investigation under various cases.

9.2 INTRODUCTION

Besides regular audit of the books of accounts of a business concern, sometimes necessity arises for thorough examination of the accounts and records of past several years to expose certain actual facts. Under such situation, the investigation of accounts is carried on. Thus, investigation is an intensive examination of accounts or records carried on by an investigator with pre-defined specific purpose according to the necessity of the situation. It is neither accounting nor audit. In most of the cases the investigation is done to ascertain the existence of fraud and the extent of mismanagement.

Investigation of Joint Stock Company is not legally compulsory like audit. In audit, the auditor performs audit as a matter of routine work at some regular interval. But in case of an investigation, an investigator has to be more searching and inquisitive in his enquiry and should go beyond the books to reveal the real facts and reasons.

9.3 MEANING OF INVESTIGATION

Investigation means an examination of the accounts and background of the business for a special purpose. It involves an inquiry into facts behind the books and accounts i.e. into technical, financial and economic position of the business or organisation for a specific purpose. Investigation is not legally compulsory under the Companies Act. Generally investigation is done to ascertain the true financial position of the company,

its profit earning capacity, the existence of fraud and the extent of mismanagement.

9.4 DEFINITIONS OF INVESTIGATION

Dicksee defines “An investigation is an examination of accounting records undertaken for a special purpose. Its object is usually to discover and display the facts in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly.” In the words of R. A. Irish “While auditing procedure may be adopted for a great deal of work, in investigation an investigator must approach his work in a critical and perhaps with a suspicious state of mind. He may be deeply concerned about what should have been done rather than confirmation of what has been done.” Further, “an investigation may be intensely interested in question of policy, a problem which is legally outside the scope of an auditor’s liability.”

According to L. R. Howard “An investigation may be defined as an examination of the accounts and balance sheet of an organisation and the supporting documents for the specific purpose of obtaining information to be submitted to an interested party.”

Spicer and Pegler define an investigation as “The term Investigation implies an examination of the accounts of a business for some special purpose.”

“Investigation involves inquiry into the facts behind the accounts i.e. into the technical, financial and economic position of the business organisation” – Taylor and Pegler



CHECK YOUR PROGRESS

Q 1: Define investigation.

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9.5 FEATURES OF INVESTIGATION

From the above definitions we can draw the following inherent features of investigation:-

1. Investigation is always undertaken for a specific purpose;
2. It is critical examination and verification of specific records for a specific period.
3. In an investigation, the scope and the nature of examination of the activity may be limited or extended;
4. Investigation is not compulsory under the Act. It is completely voluntary and contractual in nature;
5. It does not confine itself only with the financial aspect but the technical, political, economical and managerial aspects are also accounted for;
6. After completing investigation, report is to be submitted to his client, who appoints him; and
7. In investigation problems are quite different from each others as there is no specific standard procedure.

9.6 OBJECTIVES OF INVESTIGATION

The objective of investigation would differ with the purpose for which it is being undertaken. Following are the main objectives of investigation: -

(i) **Establishing a Fact:** An Investigator is to establish a fact in relation to suspected defalcation, amount of royalty payable, taxation liability, valuation of shares and debentures etc.

(ii) **Determining the reasons for a State of Affairs:** An investigator is to determine the reasons for loss, failure of internal control system, low working capital, low productivity etc.

(iii) **Evaluating a Situation:** The investigation is to find out the intention of the management in conducting the business that is whether the business is conducted with an intention to defraud creditors, members or whether the business is properly managed or not.

9.7 PURPOSE FOR INVESTIGATION

(Classification of Investigation)

The need of investigation may arise in many cases. Following are the usual circumstances which most frequently call for various types of investigation:-

a) Investigation on behalf of a person who is interested to join a partnership firm as a partner.

b) Investigation on behalf of a person or company who intends to purchase a running business.

c) Investigation on behalf of a bank or any other person who wants to lend money to a business and is interested to know its financial position.

d) Investigation in case the proprietor of the business suspected fraud.

e) Investigation on behalf of prospective shareholders who wishes to make a valuation of shares of a limited company.

f) An investigation when a person seeks different avenues of investment.

g) Investigation under the Companies Act, 2013, i.e. statutory investigation.

h) Investigation on behalf of the proprietor seeking to know the causes for the abnormal fluctuation in profits.



CHECK YOUR PROGRESS

Q 2: Mention two features of investigation.

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Q 3: Discuss the objectives of investigation.

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9.8 DISTINCTION BETWEEN AUDIT AND INVESTIGATION

Investigation of accounts is not synonymous with the audit of accounts. Auditing is a systematic examination and evaluation of economic information of an enterprise with the object of expressing an opinion thereon. On the other hand, investigation involves an inquiry into facts behind the books and accounts i.e. into technical, financial and economic position of the business for a specific purpose. Investigation is a special kind of audit with a special purpose. It differs from an audit in as much as it is not primarily carried out for the purpose of ascertaining whether a balance sheet is properly drawn on, rather for the purpose of obtaining information of a particular nature required by a client. So, the important points of distinction between the two are given below:-

Points	Audit	Investigation
Object	The object of an audit is to ascertain whether the financial statements show the true and fair view of the state of affairs of a concern.	On the other hand, objective of investigation involve inquiry into the facts behind the books of accounts for special purpose.
Scope	The scope of audit is very wide. In statutory audit the scope of audit is determined by the relevant law and in private audit, by the letter of engagement.	The scope of investigation is determined by the terms of appointment. But the investigation may
Period under examination	An audit always covers period of a year or six months.	cover several years say two to four years.
Nature of examination	Under audit the auditor draws his conclusions on the basis of test checking of accounts and records.	Investigation on the other hand, is a detailed examination. It is both intensive and exhaustive.

Nature of evidence	Under the audit the auditor is concerned only with prima facie evidence.	But in an investigation, conclusive evidence is required.
Accounting Standard	An auditor is seeing that whether accounting standards, policies and the requirements of disclosure have been complied with.	The investigator is not bound by accounting standards, policies and requirements of disclosure.
Qualification	Auditing can only be conducted by chartered accountant.	But it is not necessary that an investigator must be chartered accountant.
Legal aspects	Audit of accounts of a company is compulsory under the companies Act.	But the investigation of accounts is not legally compulsory.
Submission of report	An audit is always carried out on behalf of the proprietor; therefore, the audit report is submitted to him.	But in case of investigation the report is to be submitted to person on whose behalf it is being conducted.

9.9 ESSENTIALS OF AN INVESTIGATION

An investigation is a critical examination of the books and accounts with a specific objective. To be on the safe side, the investigator should keep on view the following essential points while conducting an investigation;

-

i) He must get in writing the reasons of investigation from the client and the period to be covered.

ii) After determining the object and the period of investigation, he should formulate a programme of investigation.

iii) He should be honest and must not be influenced by any personal bias.

iv) He should use as much skill and diligence as is necessary for an investigator.

v) If it is necessary, he should get the opinion of the experts in case of valuation of stock and other assets.

vi) If he has relied upon the audited accounts without verification of assets, he must mention that fact in his report.

vii) He should take great care to preserve his enquiries, notes, explanation gathered, working papers, etc, for future reference.

viii) The report should be simple, factual, unambiguous and concise.

ix) The investigator should be very careful in drafting the report. He must write in clear words all the work he has performed in this connection and the conclusion he has arrived at there from.

9.10 DUTIES OF AN INVESTIGATOR

If an auditor is appointed for the purpose of investigation, he should work on the following lines: -

a) Whether there has been any breach of duty by any officer.

b) Whether any loss has been caused by the negligence on the part of directors, etc.

c) Whether all the assets and liabilities of the company have been properly valued and verified.

d) Whether contracts entered into were of fair deals especially those entered into with directors or officers of the company.

e) He should interrogate directors and officers of the company or related companies.

f) If the company has got subsidiaries, he should pay attention to the inter company dealings.

g) The investigator should get written instructions regarding the scope of enquiry, its objects and the time limit by which the report has to be submitted.

9.11 LIABILITIES OF AN INVESTIGATOR

At the time of drafting the report the investigator should be very careful. He must point out all the facts in clear words all the work he has performed

in this connection and the conclusion he has arrived at there from. If he fails to point out the fact and his client relying upon such a report suffers any loss, he will be held liable for damages. The investigator should know that certain types of investigation may give evidence in civil and criminal proceedings. Thus, an investigator takes reasonable care and skill at the time of investigation. He should not be influenced by any third party at the time of preparation his report. The report should be clear, based on facts and devoid of favouritism.

9.12 GENERAL APPROACH FOR INVESTIGATION UNDER VARIOUS CASES

An investigation involves a variety of situations, it is not possible to lay down any standardised procedure. As such, the investigator has to proceed for each case with a definite framework depending on situations. The approach to any investigation is determined on a consideration of the nature of the investigation and the terms of reference.

9.12.1 Investigation on behalf of a person or company who intends to purchase a running business

An intending purchaser of business would require as much information about the business as it is possible to collect so that he can decide whether to purchase it or not and to decide on the price that could pay for it. This information would include – (1) the real position of the assets and liabilities of the business, (2) the trend of sales over the past few years, (3) the gross profit and the net profit over those years with the ratios of various expenses to the turnover and to the cost of goods sold, (4) the extent to which the net profit would be affected by the changed conditions after the purchase and (5) other non – accounting matters relevant to the purchase.

For this, the investigating accountant would examine fully the profit and loss account of a few years and the Balance Sheets

as at the end of those years to see that (a) there has been no over valuation of assets, (b) adequate depreciation and provisions have been made, (c) there has been no omission of liabilities and no inflation of profits and (d) no other manipulation that would show a raiser picture of the business than actual, (e) by testing the statements with the books, vouchers and records. The procedure for stock verification and valuation will also be carefully gone over to see (i) whether there is any obsolete stock, (ii) whether stock valuation has been uniform over the years and (iii) whether there is any inflation in stock values.

The profit and loss account would be arranged in columnar form giving details of the percentage of expenses to turnover. A statement of sales, monthly and yearly, has to be prepared and abnormal fluctuation and abnormal profits analysed. The Balance Sheet would also be arranged in columnar form for comparison over the years. The necessary ratios like, current assets to current liabilities, profit to capital, etc., will also be calculated.

A statement would then be prepared to adjust the net profit after allowing for the changes in ownership conditions. For example, if the owner had himself managed the business all these years, manager's salary has now to be charged to profit.

Other relevant matters would be noted like (i) whether the present manager who is responsible for success of the business will continue in service, (ii) whether the lease of the land and buildings comes to a close shortly and how costlier it is likely to be to renew it, and (iii) the trend regarding labour trouble in the locality.

The value of the business can now be calculated on the basis of maintainable profit and fair rate of interest on investment. Then the report is prepared in clear words, stating the period covered by the investigation, giving all the relevant information with the comments of the investigator in sufficient details for the purchaser to make his decision about the purchase of business and about the price.

9.12.2 Investigation on behalf of a client who wishes to invest in the capital

When a prospective investor desires to invest his money in a company would aim at finding out:-

(i) The present financial position of the company;

(ii) The purpose to which the invest money is to be used and its feasibility;

(iii) The adequacy of the investment for the purpose;

(iv) The quality of the management;

(v) The present profitability of the company; and

(vi) It's earning capacity in future.

As an investment is not a short – dated loan, the emphasis is not in assessing the liquidity of the concern but in estimating the future maintainable profits and the trend of the business.

Where the investors propose to invest of equity shares of a company, the investigator will look into the following points:-

(i) Future earnings;

(ii) The appointment out of them for preference dividend and reserves for working capital and the balance available for equity dividend;

(iii) The provision if any in the Articles of the company limiting the equity dividend;

(iv) The proportion of the proposed investment to the total equity capital of the company;

(v) The extent of the asset 'cover' for the capital; and

(vi) The risks in holding a minority interest in the capital.

If the investment is to be in preference shares, the investigator will look into the following points:-

(i) The terms and conditions of preference shares as laid down in the Articles of Association,

(ii) The dividend rate proposed and their relationship to the current level of interest rates,

(iii) The profit earning capacity,

(iv) The prices of the shares on the basis of prevailing rate of interest in the market,

(v) Due allowance has to be given to the risk factor and for the non – marketability of the shares,

(vi) The date of redemption of shares is also to be considered.

If the investment is in debenture, the important factors would be:-

(i) The terms of the issue should be scrutinised carefully;

(ii) Adequate provision will be made for their redemption at maturity;

(iii) The company's file at the Registrar's Office has to be verified for the existing charges on the company's assets; and

(iv) The existence of the property charged for the present debenture issued has to be verified and the value of the property also verified.

Then the report is prepared in clear word, stating the period covered by the investigation, giving all the relevant information with the comments of the auditor in sufficient detail for the purchaser to make his decision about the investment in capital (shares) and about the price.

9.12.3 Procedure of an Investigation under Companies Act, 2013

Section 210 to 229 of the companies Act, 2013 deals with the statutory investigation. Under section 210 and section 212 of the Act, the Central Government may appoint one or more competent persons as inspectors or investigators for an investigation into the affairs of a company in the following cases:-

(i) On the application by the members of the company;

(ii) On the report of the Register:

(iii) On the basis of opinion of Company Law Board; and

(iv) On other cases.

(a) On the application by the members of the company:

Investigation on application by the members of the company

is possible only if it is made by at least 200 members or members holding not less than one-tenth of the total voting power in case of a company having share capital[Section 210(a)]; and one-fifth of the members of the company having no share capital[Section 210 (b)]. The Company Law Board must also have issued a declaration as to the necessity of such an investigation.

(b) On the report of the registrar:

The registrar of a joint stock company may issue such a report if he finds that:

(i) The company has not furnished the required information or explanation asked for.

(ii) The information or explanation supplied to him by the company is unsatisfactory.

(iii) The company has not made a full disclosure of the facts.

(iv) The business of the company is carried on for a fraudulent or unlawful purpose.

(c) On the basis of opinion of the Company Law Board:

The Central Government may order an investigation if in the opinion of the Company Law Board, there are circumstances suggesting that:

(i) The business of the company is being conducted with an intention to defraud of its creditors, members or any other person dealing with the company.

(ii) The business of the company is conducted for a fraudulent or unlawful purpose or in a manner oppressive to any fraudulent or unlawful purpose.

(iii) The person concerned in the formation of the company or the management in its affairs have been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members.

(iv) The full information have not been given to the members of the company with respect to its affairs which they expect relating to the calculation of commission payable

to the management or other director or manager of the company.

(d) In other cases:

The Central Government shall appoint investigation if (a) the company by special resolution, or (b) the court by order declares that the affairs of the company ought to be investigated by an inspector or investigator appointed by the Central Government.

9.12.4 Investigation on behalf of the proprietor seeking to know the causes for the abnormal fluctuation in profits

Unusual fluctuation in the profit on sales might arise either by an error or a fraud of proprietors or employees or by an intentional change in the financial policy in the business. The investigation in case of fluctuation in the profit is done by the investigator in the following manner:

(i) Check the purchase invoices of various periods if there is unusual decrease in the cost of purchase without decrease in selling price;

(ii) Detailed checking the purchase records of the last few days, if the new purchases are included in the stock but not recorded in the purchases day book;

(iii) Examine the method of stock taking and their valuation;

(iv) He should also see that goods not recorded in purchases book and goods sold out but not delivered should be excluded from stock;

(v) He should thoroughly vouch the outwards invoices and return inward book to find out recording of fictitious sales which will increase gross profits;

(vi) He should analyse the composition of sales and see whether there is any appreciable increase in the sales because the rate of gross profit increase with the increase in sales;

(vii) He should make a comparison of current year's sales with those of previous year and any abnormal increase in the current year sales should be thoroughly investigated;

(viii) He should examine all the outstanding debtors balance with the credit note which will establish genuiness of sales;

(ix) He should also examine the market price of the goods bought and sold and general trend in gross profit with other units.

After completion of investigation, the investigator should prepare a report in clear language and submit it to the concerned authority.

9.12.5 Investigation on behalf of a person who is interested to join a partnership firm as a partner

The incoming partner will like to know the profitability, sound financial state of affairs of the business. In order to provide such information, the investigator must pay attention to the following points: -

(a) He should examine the reason as to why the old partners are permitting new person join their partnership firm;

(b) He should study the proposed partnership agreement thoroughly to ensure its fairness and truthfulness;

(c) He should enquires about the financial position of all the partners;

(d) He should see that whether the capital to be introduced by his client, will be used for paying back any old liability or utilised in the business for expansion;

(e) If the new partner is admitted in place of retiring or deceased partner, he has to see whether the firm will suffer any loss by the absence of such partner and such a loss will be made good by skill and experience of the incoming partner;

(f) He should ensure that whether the past earnings, reputation and the future prospect of the concern justify the goodwill amount being brought in by his client;

(g) He should compare the old partners capital with their proportion of share in the profit or loss of the firm;

(h) He should examine the profit and loss account and the balance sheet of the firm for some years in order to ascertain the trend of growth of the business over the years;

(i) He should see whether any specialised or technical knowledge is necessary for the successful conduct of the business and whether existing partner has that;

(j) He should verify the existence of assets and study the method of valuation of assets both fixed and current;

(k) He should verify the existence of liabilities and examine its obligations;

(l) He should also ascertain the tax – liability of the firm;

(m) After considering all the above facts the investigator should formulate some important ratios for his arriving at a conclusion.

Then the report is prepared in clear language, stating the period covered by the investigation, giving all the relevant information with the comments of the auditor in sufficient detail for his client to make his decision about join the partnership firm as a partner.

9.12.6 Investigation on behalf of a bank or any other person who wants to lend money to a business and is interested to know its financial position

A bank or any other individual (private) lender interested in granting a loan would like to assess the financial position and repaying capacity of the borrower. An investigator who undertakes investigator who undertakes investigation on behalf of such a lender should keep following factors into consideration:

(a) He should study the circumstances which are responsible for the need of loan.

(b) He should study the period for which loan is required.

(c) He should examine that whether the security being offered is adequate to cover the amount of loan.

(d) He should ensure that whether personal guarantees are being provided along with appropriate security.

(e) He should examine the amount of loan in relation to the capital.

(f) He should study the personal status of the directors/partners/ proprietor.

(g) He should examine the balance sheet to ascertain –

- Amount due from directors, partners, sister concerns etc.,
- Method of valuation of inventory,
- Market/realisable value of fixed assets and investment,
- Adequacy of provision for bad and doubtful debts,
- Existence of any charge on assets, and
- Long term liabilities of the entity, their duration and rate of interest,etc.

(h) He should find out whether any other party in the past has refused to give loan to the concerned party and what were the reasons for that.

(i) If the loan is applied by joint stock company, the investigator has to ensure that the proposed loan is within the borrowing powers of the directors.

(j) The ratio of current liabilities to the liquid assets should be properly ascertained by the investigator.

(k) In case of loan for a new project, the lender should pay attention all the above points and ascertain:-

- Gestation period;
- Time required by the project to complete all its phases;
- Estimated net present value should be calculated, if net present value is positive only then finance is provided.

The report is prepared in clear language, stating the period covered by the investigation, giving all the relevant information in sufficient detail for his client to make his decision about the granting of loan.

9.12.7 Investigation in case the proprietor of the business suspected fraud

Investigation in case of suspected frauds usually conducted on behalf of a proprietor. When fraud is suspected, the nature of work required of the investigating accountant will depend on the instructions. Fraud is generally committed in the following ways: -

(i) Cash Defalcations: - The investigation in the cash defalcations is done in following ways –

- The internal check system should be verified in regard to cash receipts and payments;
- He should ask for explanation in case of any missing cash memos;
- He should verified all the payment in respect of salaries and wages and ascertain that they are authenticated;
- He should properly checked the petty cash payments;
- He should properly scrutinise the discount or allowances. Sometimes mor discount is entered then actually allowed;
- He should enquire as to who is authorised to sign the endorsement of the cheques to avoid any misappropriation;
- He should properly examine the list of Bad Debts to ensure that they are really bad debts;
- The receipts from the debtors should be verified from the counterfoil of the receipts books. He should also verify the actual balance standing against their respective names.

(ii) Wage Defalcations : - The investigation in case of wage defalcations is done in following ways –

- Internal control system should be checked;
- He should checked entries in the wage sheets with original documents;

- He should ensure that employment of workers whose names appear in the wage sheets. This is important to check the inclusion of 'dummy workers' in the wage sheet.

(iii) Misappropriation of goods : - The investigation regarding misappropriation of goods is done in the following manner :

- He should checked the internal control system and any weakness should be noted for particular attention;
- He should thoroughly check the issue and receipt system of goods;
- He should see that the stock accounts are up – to – date;
- He should further check the Order Received Book, Sales Book, Godown Keeper's Book and invoices;
- He should give special attention regarding the method of valuation of stock and the prices used for such valuation.

(iv) Manipulation of Accounts: - Fraud relating to manipulation of accounts are very difficult to discover. The accountant should adopt such procedures for investigation as he thinks are necessary. He must –

- Pay special attention to verification of assets and liabilities.
- Conduct extensive cut – off tests.
- Try to obtain evidence from outside for confirming the transactions recorded in the books of account.
- Adopt detailed of vouching and verification to trace such frauds.



CHECK YOUR PROGRESS

Q 4: Mention two cases for which the Central Government may appoint investigators for an investigation into the affairs of a company.

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9.13 LET US SUM UP

In this unit we have discussed the following aspects-

- Investigation is an intensive examination of accounts or records carried on by an investigator with pre-defined specific purpose according to the necessity of the situation.
- Investigation is not compulsory under the Companies Act. It is generally done to ascertain the true financial position of the company, its profit earning capacity, the existence of fraud and the extent of mismanagement.
- Establishing a fact, determining the reason for a State of Affairs, evaluating a Situation etc. are the main objectives of investigation.
- Investigation differs substantially from an audit assignment. An investigation seeks substantive and in some case even conclusive evidence as compared to audit which mainly relies on persuasive evidence.
- An investigator should take reasonable care and skill at the time of investigation. The report of the investigator should be clear, based on facts and devoid of favouritism.



9.14 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). Principles and practice of Auditing, New Delhi, Himalaya Publishing House.

4) ICAI (2016). Advanced Auditing and Professional Ethics, Study Material, ICAI, New Delhi.

9.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Dicksee defines "An investigation is an examination of accounting records undertaken for a special purpose. Its object is usually to discover and display the facts in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly."

Ans to Q No 2: Two important features of investigation are:

1. Investigation is always undertaken for a specific purpose;
2. It is critical examination and verification of specific records for a specific period.

Ans to Q No 3: Following are the main objectives of investigation: -

(i) Establishing a Fact

(ii) Determining the reasons for a State of Affairs

(iii) Evaluating a Situation

Ans to Q No 4: (i) On the application by the members of the company.

(ii) On the report of the Register



9.16 MODEL QUESTIONS

Q 1: Explain the meaning of Investigation.

Q 2: Explain the purpose for Investigation.

Q 3: Distinguish between Audit and Investigation.

Q 4: Discuss the essentials of an Investigation.

Q 5: Discuss the liabilities of an Investigator.

Q 6: Discuss the approach to an investigation under Companies Act, 2013.

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UNIT 10: COMPANY AUDITOR

UNIT STRUCTURE

10.1 Learning Objectives

10.2 Introduction

10.3 Qualification of Company Auditor

10.4 Appointment of Company Auditor

10.5 Rights of Company Auditor

10.6 Duties of Company Auditor

10.7 Liabilities of Company Auditor

10.8 Removal of Company Auditor

10.9 Let Us Sum Up

10.10 Further Readings

10.11 Answers To Check Your Progress

10.12 Model Questions

10.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the qualification and disqualification of company auditor
- discuss about the appointment of company auditor
- explain the duties and liabilities of company auditor
- explain the removal of company auditor.

10.2 INTRODUCTION

The audit of the accounts of the companies has been made compulsory by the Indian Companies Act, 2013. The shareholders of a company invest their capital but they entrust the management and contact of the company in the hands of directors who may be some shareholders amongst themselves or some professional managers. The directors who get the power to free use of the resources of the company and the accounts of the company are also prepared by the management. For this reason, the shareholders seek the opinion from the experts on the authenticity of

the accounts of the company and whether their interest are protected or not. The auditor carries out this task and presented his report to the shareholders.

The company audit has some special features. The Companies Act, 2013, provides some provisions regarding qualifications, powers, duties and labilities of the auditors. The Act specifies the procedures regarding appointment, reappointment, removal of the auditors and fixation of their remuneration. This Act have also been prescribed the form and contents of the balance sheet and profit and loss account.

10.3 QUALIFICATION OF COMPANY AUDITOR

Section 141 of the Companies Act, 2013 lays down the provisions regarding the qualification and disqualifications of a company auditor. Sections 141 (1) and 141 (2) provide that the auditor must possess the following qualifications :

(a) As per Section 141 (1), a person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant :

Provided that a firm whereof majority of partners practicing in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company.

(b) As per Section 141 (2), where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorized to act and sign on behalf of the firm.

Disqualifications : According to Section 141 (3), the following persons shall not be eligible for appointment as an auditor of a company, namely :

(a) A body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) An officer or employee of the company;

(c) A person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) A person who, or his relative or partner-

(i) Is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company:

Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

(ii) Is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or

(iii) Has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;

(e) A person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

(f) A person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) A person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies

(h) A person who has been convicted by a court of a offence involving fraud and a period of ten years has not elapsed from the date of such conviction;

(i) A person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.

(j) Explanation- For the purposes of this clause, the term "directly or indirectly" shall have the meaning assigned to it in the Explanation to section 144.

Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.



CHECK YOUR PROGRESS

Q 1: Mention any two people who are not qualified to act as or a company.

i) .....

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ii) .....

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10.4 APPOINTMENT OF COMPANY AUDITOR

Every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting. Before making any such appointment, the written consent of the auditor to such appointment, and a certificate from him or it that the appointment, if made, shall be obtained from the auditor. The certificate obtained from the auditor shall also indicate whether the auditor satisfies there criteria provided in Sec 141. The company shall inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed. No listed company or a company belonging to such class or classes of companies, shall appoint or re-appoint-

(a) An individual as auditor for more than one term of five consecutive years; and

(b) An audit firm as auditor for more than two terms of five consecutive years.

(I) Appointment of First Auditor : The first auditor of a company, other than a Government company, shall be appointed by the Board of Directors within thirty days from the date of registration of the company and in the case of failure of the Board to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting. And in the cases of a Government Company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within sixty days from the date of registration of the company and in case the Comptroller and Auditor-General of India does not appoint such auditor within the said period, the Board of Directors of the company shall appoint such auditor within the next thirty days; and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting, who shall hold office till the conclusion of the first annual general meeting.

(II) Appointment in Government Companies : In the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the Comptroller and Auditor-General of India Shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of one hundred and eighty days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

(III) Appointment in Casual Vacancy : Any casual vacancy in the office of an auditor shall-

(a) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days, But if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting;

(b) In the case of a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Comptroller and Auditor-General of India within thirty days. In case the Comptroller and Auditor-General of India does not fill the vacancy within the said period, the Board of Directors shall fill the vacancy within next thirty days.

iv) Reappointment of an auditor : A retiring auditor may be re-appointed at an annual general meeting, if-

(a) He is not disqualified for re-appointment;

(b) He has not given the company a notice in writing of his unwillingness to be re-appointed; and

(c) A special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

Further, if no auditor is appointed or re-appointed at any annual general meeting, the existing auditor shall continue to be the auditor of the company. Where a company is required to constitute and Auditor Committee under Sec 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

10.5 RIGHTS OF COMPANY AUDITOR

The Companies Act, 2013 has conferred several powers upon the auditor of a company so that he may discharge his duties effectively and fulfil the objectives satisfactorily. The principal rights are mentioned below:

(i) Right to access at all times to books, accounts and vouchers of the Company :- Section 143(I) confers upon the auditor right access at all times to books, accounts and vouchers of the company whether kept at the head office or elsewhere.

(ii) Right to obtain information and explanations:- As per Section 143(I) of the Companies Act, the auditor has a right to call for any explanation or information from the employees and officers including managing director and director of the company which he thinks necessary for the purpose of audit and proper discharge of his duties. In case any information or explanation is not furnished to him, he may mention this in his audit report.

(iii) Right to receive notice of and attend general meeting :- As per Section 146, the auditor has a right to receive all notices of an other communications relating to any gereral meeting of a company and to attend any general meeting irrespective of the fact. Whether the matter relating to ascents are being discussed or not . He has a right to speak at such meeting when the accounts are being discused. But he may a may not exercise this right.

(iv) Right to visit branch office:- The auditor can visit any branch office if he deems it necessary to perform his duties. He has the right to access at all times to the books of accounts and the virtues of the company maintained at the branch office.

(v) Right to sign audit report (Section 145):- Only the person appointed as auditor of the company, or where a firm is so appointed, only a partner of the firmpractising in India may sign the auditors report, or sign a authoritative any other documents of the company required by how to be signed a authoritative by the auditor.

(vi) Right to remuneration [Section 142] : An auditor has the right to receive the remuneration provided he has completed the work he undertook to do. Where the auditor is appointed to audit the annual accounts and subsequently is dismissed before the completion of audit he is entitled to claim the full years remuneration.

(vii) Right to indemnified :- The auditor has a right to be indemnified act of the assets of the company against any liability incurred by him in defending himself against civil and criminal proceedings by the company provided he is acquitted of the charges or judgment is given in his favor or the court in of opinion that the auditor acted honestly.

(viii) Right to legal and technical advice:- He has the right to take legal, expert a technical advice but he must give his opinion in the report and not that of expect, lawyers etc.

(ix) Right of Lien:- Auditor has a right of lien over the working papers or documents he gets possession of during the cause of audit. However, he does not possess the right of lien the books of accounts of the company, in general. He can refuse to give his working papers relating to the audit of the company.



CHECK YOUR PROGRESS

Q 2: Mention any two right of company auditor.

i) .....

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ii) .....

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10.6 DUTIES OF COMPANY AUDITOR

The duties of an auditor under the Companies Act may be discussed under the following heads:

- Duty to Report
- Duty to Enquire
- Duty to make statements an additional matters

- Duty to assist investigator

  Specified by the central Government
- Other Statutory Duties.

1. **Duty to report :** As per Section 143 (2), the auditor shall make a report to the members on the accounts examined by him and as every balance sheet and profit and loss account and on every documents declared to be a part of a annexed to the balance sheet or profit and loss account, laid before the company in the general meeting during his tenure of office.

   The auditor's report shall also state-

   (a) Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

   (b) Whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purpose of his audit have been received from branches not visited by him;

   (c) Whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

   (d) Whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

   (e) Whether, in his opinion, the financial statements comply with the accounts standards;

   (f) The observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) Whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

(h) Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) Whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls;

(j) Such other matters as may be prescribed.

(k) Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons

2. Duty to Enquire :

The auditor is required to make enquiries into following matters. These are :

(i) whether the loans and advances made on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company or its members.

(ii) whether transactions of a company, which are represented merely by book entries are not prejudicial to the interest of the company.

(iii) in case of companies other than investment companies or banking companies, whether assets of the company such as shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

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

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

(vi) if shares have been allotted for cash, whether the cash has been actually received and, if not received, whether the position has

been correctly reflected in the balance sheet in a manner that is correct and not misleading.

3. **Duty to make statements on additional matters specified by the central Government :** The central Government has power to issue suitable instructions to auditors to report an certain additional matter in the audit report of classes of companies notified.
4. **Duty to assist investigator :** The audita should assist the Inspector in every possible ways when the affairs of the company are being investigated. He can be asked to produce the working papers for this purpose.
5. **Other Statutory Duties :** If an existing company issued prospectus the auditor has to prepare certain reports to give financial information as required by the Companies Act. Such reports includes statement of profits and losses, statement of assets and liabilities, rates of dividends paid for each classes of shares for previous five years.
   (i) Duty to certify the contents of statutory report
   (ii) Duty to report under voluntary winding up
   (iii) Duty to attend Audit Committee Meetings.

10.7 LIABILITIES OF COMPANY AUDITOR

The liabilities of the auditor of a limited company in relation to his work has been expressly mentioned in various statutes including the Companies Act,2013 and has also been established by pronouncements of the courts.

The liabilities of an auditor can be discussed as under :

(i) Liability for negligence under law of Agency :
   (a) Civil liability for negligence towards clients
   (b) Civil liability for negligence towards third parties.

(ii) Civil and Criminal Liabilities under statute (Misfeasance)
   (a) Under the Companies Act, 2013.
   (b) Under the Income Tax Act, 1961.

Civil liability involves a violation of the rights of same specific party and penalty is in the form of payment of damages. Again criminal liability

occurs when an act considered to be wrong against society is committed and the offender can be fined or imprisoned or both.

(i) Civil liability for negligence :

The client and third parties can sue the auditor for negligent discharge of his duties under law of Agency.

(a) Liability for negligence towards clients :

Negligence means the failure to exercise reasonable care and skill which is expected of an auditor while conducting audit such expectation arises from the importance of professional services ended by an auditor to his client. Thus, the auditor will be held liable for his acts of mission and commission, such as failing to detect defalcation, relying upon certificate as to valuation of stocks given by the management, payment of dividends, act of capital etc.

Liability for damages for negligence : In under to held an auditor liable for negligence, it must be proved :

(a) that he was negligent

(b) that as a result of his negligence the client suffered a loss and

(c) the loss was suffered by person to whom the auditor owed

(B) Liability for negligence towards third parties :

There are several interested parties such as auditors, bankers, potential investors etc. rely completely upon the auditors report to take important decisions and enter into transaction with the company without any further enquiry. His liability in cases of fraudulent misrepresentation resulting in physical injury or financial damage to third parties. However, the liability of the auditor for negligently a statements is a matter of controversy.

An auditor is to be held liable to the third parties subject to the fulfillment of the following conditions :

(i) The third party must have suffered a financial, loss;

(ii) The loss has been resulted by the reports, accounts, statements prepared by the auditor,

(iii) The auditor knew or ought to have known that the report, accounts, financial statements were prepared for specific purpose or transactions which gave rise to the loss,

(iv) The auditor knew or ought to have known that they would be shown to and relied upon by the third party;

(v) The auditor was negligent in the preparation of such reports, accounts and statements.

Liabilities under Companies Act, 2013

According to Sec 147(2), if an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, the auditor shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees or four times the remuneration of the auditor, whichever is less. And if the auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a term which may extend to one year including fine which shall not be less than fifty thousand rupees but which may extend to twenty-five lakh rupees or eight times the remuneration of the auditor, whichever is less. Further, he shall be liable to-

(i) Refund the remuneration received by him to the company; and

(ii) Pay for damages to the company, statutory bodies or authorities or to members or creditors of the company for loss arising out of incorrect or misleading statements of particulars made in his audit report.

The Central Government shall, by notification, specify any statutory body or authority or an officer for ensuing prompt payment of damages to the company or to the above mentioned persons. Such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

In case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal

as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally. In case of criminal liability of an audit firm, in respect of liability other than fine, the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud shall only be liable.

Liabilities under the Income Tax Act :

A professional accountant often advises his client as income tax matters and acts as an representative of his clients before the income tax authority or the appellate tribunal in connection with proceedings under the Act. His criminal liability has been prescribedin the meance tax Act under Section 278, 288 and Rule 12 A of the Income Tax Rules.

(i) Section 278 of Income Tax Act : For abetting or inducing the filing of a false account, statement or declaration, the accountant shall be punishable with an imprisionment which may extend to seven years if tax evaded exceeds one lakh rupees otherwise three years and fine.

(ii) Section 288 of Income Tax Act : In case of a chartered accountant is found guilty of misconduct in his professional capacity by the Council of the Institute of Chartered Accountants of India, he cannot act as an authorised representative for such time that the order of the council disqualifies him from practising.

(iii) Rule 12 A of the Income Tax Rules , false information in return: If the return submitted contains any information which is false and which the chartered accountant either knows a believes to be false or untrue, he would be liable to imprisionment which may extend to seven years and five.

Liability under other Acts:

As per Section 46 of the Banking Companies Act, 1940, if an auditor in any return, balance sheet or other documents, wilfully makes a statement which is false in any material statement, he is punishable with imprisionment for a term which may extend to three years and fine. Under Section 46, he is deemed to be a public servant for the purposes of Indian Penal Code.

10.8 REMOVAL OF AUDITOR BEFORE THE EXPIRY OF THE TERM

According to Sec 140 (1), the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf. But before taking any action under this sub-section, the auditor concerned shall be given a reasonable opportunity of being heard. Further, without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either so motto or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors. If the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place. An auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

Removal of auditor after the expiry of the term :

Section 140 has laid down the procedure for removal of the retiring auditor and appointment of a new auditor in his place. The procedure is as follows:

(i) Special notice : Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor

has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139.

(ii) Forwarding a copy of the notice to the auditor : On receipt of notice of such a resolution, the company shall forth with send a copy thereof to the retiring auditor.

(iii) Right to make representation : Where notice is given of such a resolution and the retiring auditor makes with respect thereto representation in writing to the company (not exceeding a reasonable length) and requests its notification to members of the company, the company shall, unless the representation is received by it too late for it to do so,-

(a) In any notice of the resolution given to members of the company, state the fact of the representation having been made; and

(b) Send a copy of the representation to every member of the company to whom notice of the meeting is sent, whether before or after the receipt of the representation by the company,

And of a copy of the representation is not sent as aforesaid because it was received too late or because of the company's default, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.



10.9 LET US SUM UP

In this unit, we have discussed the following aspects:

- the qualification and disqualification of company auditor as per Section 141 under the Companies Act, 213.
- under Section 139, the appointment of company auditor.
- the different rights and liabilities covered under Companies Act, 2013.
- the removal of company auditor.



10.10 FURTHER READINGS

1) Basu S. K. (2008), *Auditing : Principles and techniques*. New Delhi, Pearson Education Ltd.

2) Gupta K. (2005). *Contemporary Auditing*. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). *Principles and practice of Auditing*. New Delhi, Himalaya Publishing House.

10.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: According to Section 226 (3), the following persons are not qualified to act as auditor of a company -

(i) a body corporate;

(ii) an officer or employee of the company.

Ans to Q No 2: The rights of company auditor are :

(i) Right to access at all times to books, accounts and vouchers of the Company as per Section 143(I). The auditor has the right to access at all times to books, accounts and vouchers of the company whether kept at the head office or elsewhere.

(ii) Right to obtain information and explanations:- As per Section 143(I) of the Companies Act, the auditor has a right to call for any explanation or information from the employees and officers including managing director and director of the company which he thinks necessary for the purpose of audit.



10.12 MODEL QUESTIONS

Q 1: What are the qulifications to be company auditor?

Q 2: How company auditor can be appointed?

Q 3: Mention the different rights of company auditor?

Q 4: What are the different rights and duties of compnany auditor?

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UNIT 11: AUDIT OF SPECIAL ORGANISATION

UNIT STRUCTURE

11.1 Learning Objectives
11.2 Introduction
11.3 Audit of Charitable Institutions
11.4 Audit of Clubs
11.5 Audit of Hotels
11.6 Audit of Hospitals
11.7 Audit of Educational Institutions
11.8 Audit of Cinema Hall / Theatres
11.9 Audit of Co-operative Society
11.10 Let Us Sum Up
11.11 Further Readings
11.12 Answer To Check Your Progress
11.13 Model Questions

11.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- understand the procedures to be adopted for auditing Not-for-profit Organisations (NGOs), Charitable Institutions
- discuss the important points to be considered in the audit of special entities.

11.2 INTRODUCTION

We have already discussed in the earlier chapters that the general procedure of audit are common to all audits. However, functioning differences, scope of internal control etc. of different types of entities causes the auditor to emphasize on special areas or items which is very important from the perspective of audit of such organisations. In this chapter we shall discuss special points to be considered / audit programme of –

- A Charitable Institution;
- A Club;

- A Hotel;
- An educational Institution;
- A Cinema Hall;
- A Co – operative Society;
- A Hospital;

11.3 AUDIT OF CHARITABLE INSTITUTIONS

The audit procedures which may be adopted for audit of accounts of a charitable institution are given below: -

a) Preliminary work:

I) The auditor should ascertain the legal status of the institution, the powers of the trust board and the rules regarding accounts and audit by examining the relevant Act, the trust deed and other documents.

II) He should study the internal control system and see that the accounts are drawn up according to rules.

III) He should examine the minutes book of the meeting of managing committee/governing body/board of trustee to obtain information about important decision.

IV) He should verify the latest audit reports and note down important qualifications and observations.

b) Receipts and Payments:

I) He should satisfy himself that all the expenditure is in accordance with the objects of the charity.

II) He should check donations and subscriptions with counterfoils of receipts and the cash book.

III) He should vouch the receipt of legacies with the legacy register and correspondence with solicitors.

IV) He should vouch income from investments, rent and other sources.

V) He should vouch carefully the expenditure and see that they are properly apportioned between capital and revenue.

VI) He should see funds received for special purposes are used for the purpose stated.

VII) He should see that any income tax paid on interest or dividend has been duly recovered, as charitable institutions are not usually liable for income tax.

c) Assets and Liabilities:

I) He should verify the cash in hand and at bank.

II) He should verify all assets and liabilities in the usual manner and ensure that they are properly disclosed and valued

III) He should see that his reports are set out in the way prescribed by the Act or its rules, if any.

11.4 AUDIT OF CLUBS

The following special points should be noted in the audit of the accounts of a club –

a) Preliminary Work :

I) The auditor should examine the constitution of the club – its rules and regulations to ascertain the financial and administrative powers of the chairman or president and other committee officials.

II) He should check minute book of the club to know the resolution passed by the managing committee and general members at the annual meeting.

III) He should ascertain powers of the officials and procedure of operation of the bank accounts.

IV) He should examine the audit reports of the last few years and note the important observations and qualification.

b) Receipts and Payments:

I) He should examine the subscription received during the year, arrear subscriptions and subscription received in advance with the counterfoils of the cash book and the register of member.

II) He should vouch the entrance fees and also see that whether any admission fees have been received by the club.

III) He should check the income from sale of refreshments, meals, drinks and supply of special services.

IV) He should vouch the income received by the club from any annual function held by the club.

V) He should see that proper books of accounts are maintained for stock of refreshment, eatables, wines, cigars, cloths etc.

VI) He should see that if any donation has been received for specific purpose, have been utilised for the purpose only.

VII) He should vouch the payment made on account of purchase of crockery, eatables, wines, cigars, furniture, etc.

c) Assets and Liabilities:

I) He should see that adequate depreciation on the assets has been charged.

II) He should see that proper distinction is made between capital and revenue expenditures.

III) He should verify assets such as inventory of provisions, stock of sports materials, furniture etc. by adopting suitable audit procedures.

IV) He should check the cash and bank balance and see that bank account has been operated by the authorised person.

V) If donation is received by the club, it should be ensured such funds are used for the specified purpose only.



CHECK YOUR PROGRESS

Q 1: State any two preliminary works of an auditor in an audit of charitable institutions.

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Q 2: State any two special points to be considered while verifying assets and liabilities of Clubs.

.....

11.5 AUDIT OF HOTELS

The following special points should be noted in audit of the accounts of a hotel –

a) Preliminary Work: - The auditor should enquire into the internal control system in operation, particularly concerning receipts of cash and

accounting thereof by the waiters, etc., provisions, stores, wine purchases.

b) Receipts and Payments:

I) He should enquire into the system of accounting for billing of customers and the system of control in operation.

II) He should examine collaboration agreement with a foreign hotelier, department of tourism, etc. and see the terms of such agreement.

III) He should examine the vacancy rate by referring to the booking register and compare the same with that of the preceding year.

IV) He should examine the visitors' ledger and vouch daily totals.

V) He should examine the licence issued to the hotel and the range of facilities the hotel is required to provide.

VI) He should verify the receipts of bar, billiard room or from casual visitors' for meals, liquor, etc.

VII) The adequate provisions should be made for depreciation of fixture and fittings, crockery, table cloths, glass, utensils, beds, etc.

VIII) All the petty cash account should be thoroughly verified with the books of accounts, if necessary.

IX) The payment of salaries and wages should be properly vouched.

X) He should see that proper allocation has been made between capital and revenue.

XI) He should examine the room rents and bar receipts and see that they are separately recorded.

XII) He should check any grants received from government and see that whether such grants are properly utilised.

XIII) He should vouch the collection of the dues from the travel agents in respect of booking for visitors.

c) Assets and Liabilities:

I) He should verify the stocks and their mode of valuation.

II) He should verify the assets and liabilities as shown in the balance sheet.

III) He should physically verify cash in hand and at bank.

IV) He should examine whether all the assets and liabilities have been properly disclosed.

11.6 AUDIT OF HOSPITALS

The audit procedures which may be adopted for audit of accounts of a hospital are given below –

a) Preliminary Work:

I) He should examine the 'Trust Deed', Bye – laws and minutes of the executive committee for the matters which may affect the accounts.

II) He should evaluate and study internal control system in operation.

b) Receipts and Payments:

I) He should check the income from donations with the list of donors and counterfoils of receipts issued.

II) He should vouch the grants received from local authorities with correspondence and ensure that they are properly utilised.

III) Receipts from rent, dividend etc. may be vouched as usual.

IV) He should see that legacies, donations etc. made for a particular purpose are applied accordingly.

V) He also see that all outstanding income and expenditure have been included in the accounts.

VI) He also see that all expenditure have been properly apportioned between capital and revenue.

VII) He should vouch the payment of salaries to the staff.

VIII) He should check the income from investment. Sometimes hospitals are exempted from paying the income tax on their income arising from investment and other sources. In that case, he should see that no income – tax is paid.

IX) If any fund is earmarked for a specific purpose, he should see that it is applied towards the same purpose.

X) He should vouch the bill register of patients with the carbon copies of the bills sent to patients.

XI) He should compare the bills with the attendance register of the patients.

XII) He should compare the collections from the patients with the patients register, copies of the bills and the cash book.

c) Assets and Liabilities:

I) He should vouch the purchases of linen, furniture, medicines and other equipment in the usual way. He should also ensure that the purchases of these items are duly authorised.

II) He should verify furniture, filings, apparatus and stock in hand.

III) He should check the system of issuing medicines, linen, surgical instruments from the main stores to the stores of the different wards.

IV) He should see that proper provisions for depreciation have been made for fixed assets.

V) He should physically verify cash, investments and bank balance.

11.7 AUDIT OF EDUCATIONAL INSTITUTIONS

The auditors of school or college are, generally, appointed by the management of the trust or society and in case of university, appointment of the auditors in according to the provisions of statute governing it. The auditor may adopt the following audit procedure: -

a) Preliminary Work:

I) He should carefully study the regulations, copy of the Trust Deed Act, in case of school or college and ordinance in case of university.

II) He should ascertain the mode of management and the rules, which affect the accounts.

III) He should study the minute books of the Managing Committee or Governing Body or Executive Council and Finance Committee and see that the resolutions affecting the accounts have been duly complied with.

IV) He should thoroughly assess the strength of internal check system in operation.

V) He should obtain a list of persons who can authorise the financial transactions and those who disburse the money involved.

b) Receipts and Payments: -

I) He should vouch the government grants, if any.

II) He should verify the collection of monthly fees from students

with counterfoils or carbon copy of the receipts. He should also see whether cash received has been banked daily or not.

III) He should carefully verify other charges from the students such as examination fees, laboratory fees, fines, etc.

IV) Any fees received in advance should be properly adjusted.

V) 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.

VI) He should check whether any grant – in – aid or funds received for particular purpose must be utilised for the same.

VII) He should see that the donations and other subscriptions from various authosrities have been accounted for and acknowledged.

VIII) The income from property, investment, etc., should be carefully verified from the vouchers.

IX) He should vouch the amount of salaries paid with the salary register and any increment given to an employee shall be duly sanctioned by the competent authority.

X) He should check the provident fund accounts of the staff and see that the funds are properly invested.

XI) He should carefully vouch all the establishment expenses.

XII) He should verify the payment of scholarship with the receipt from students and scholarship register.

c) Assets and Liabilities:

I) He should also see that the investments made by these institutions are in accordance with the requirements of rules.

II) He should also examine the system of recording of furniture's, library books, stationery, sports items and other equipments.

III) He should carefully ascertain whether stock – taking is done every year or not.

IV) He should ensure that whether all the assets and liabilities are properly discloses in the Balance Sheet.

V) He should ensure that proper allocation has been done between capital and revenue expenditure.

11.8 AUDIT OF CINEMA HALL / THEATRES

The auditor should take care of the following special points: -

a) Preliminary Work:

I) He should examine the terms and conditions of the contracts between the cinema company and the film producers or distributors.

II) He should examine the nature of the business, i.e., whether it is a sole – proprietorship or a partnership firm or a company.

III) He should verify the clauses with regard to the sharing of profits or losses in case of a partnership business.

IV) He should enquire into the internal check system of daily receipts from the sale of tickets. He should check it with the portion of the counterfoils of tickets and the daily summery of the returns of tickets sold for the various shows.

b) Receipts and Payments:

I) He should verify the total of daily returns of tickets sold with the entries in the cash book.

II) He should see that the money received on account of advance booking of the tickets should be carried over.

III) He should see that the proceeds of entertainment tax have been correctly dealt with.

IV) Receipts from advertisement shown on screen (slides) should be checked from the advertisement contracts books and other documentary evidences.

V) He should vouch the payments of salaries to staff, wages, electricity and other purchases as usual.

VI) He should check the proper allocation is made between capital and revenue expenditure.

VII) He should verify expenses such as repairs, renewals maintenance, renovation, etc., with reference to appropriate sanctioning authority and relevant vouchers.

VIII) He should ensure that the proceeds of entertainment tax collected should be properly accounted.

c) Assets and Liabilities:

I) As cinema furniture suffers greater depreciation, a higher rate of depreciation should be charged to such an asset.

II) He should see that machineries and buildings are properly valued after providing for adequate depreciation.

III) He should see that unused tickets are maintained under lock and key.

IV) He should check all liabilities should be disclosed at correct values.

11.9 AUDIT OF CO – OPERATIVE SOCIETIES

The auditor may adopt the following steps to audit the accounts of a co – operative society

a) Preliminary Work:

I) He should have a complete knowledge of the Societies Act, 1912, and the Bye – Laws of the society concerned.

II) He should thoroughly examine the membership register in order to ascertain the number of shares held by each member.

III) He should study its management and ascertain the powers of the officers.

IV) He should examine the adequacy of internal control system to determine the extent of reliance which may be placed on it.

b) Receipts and Payments:

I) He should vouch the cash receipts on account of deposits with the cash book counterfoils of the receipt book.

II) He should vouch the interest received from borrowers or return of loan from them, with the agreement between the borrower and the society, counterfoils of the receipt book, cash book, etc.

III) He should examine the cash book for the money borrowed from the bank and vouch its correspondence with the lender and other relevant documents.

IV) He should vouch cash received by way if share capital with cash book, register of members and copies of receipts issued to them.

V) He should examine whether the payments, made have been properly authorised and vouch them in usual manner.

VI) He should ensure that the dividends, if distributed, do not exceed the rate mentioned in the Act or by laws.

VII) He should examine the overdue debts, if any.

c) Assets and Liabilities:

I) He should physically verify cash in hand and cash at bank, investment held by inspecting them and comparing them with the relevant account.

II) He should verify and examine the stock and the method of valuation of stock.

III) He should physically verify the furniture and stationery.

IV) He should ensure that required percentage of profits transferred to reserve fund, welfare fund and other funds as the requirement of the Act and by laws.

V) He should verify the other assets and liabilities, if any, in the usual manner.



11.10 LET US SUM UP

- While conducting audit of special entities, the auditor need to consider certain areas or items very carefully to make the audit work effective.
- Special entities include Charitable Institutions, Clubs, Hotels, Educational Institutions, Cinema Hall, Co-operative Societies, Hospitals etc.



11.11 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). Principles and Practice of Auditing, New Delhi, Himalaya Publishing House.



11.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1:

i) The auditor should ascertain the legal status of the institution, the powers of the trust board and the rules regarding accounts and audit by examining the relevant Act, the trust deed and other documents.

ii) He should study the internal control system and see that the accounts are drawn up according to rules.

Ans to Q No 2:

i) He should see that adequate depreciation on the assets has been charged.

ii) He should see that proper distinction is made between capital and revenue expenditures.

11.13 MODEL QUESTIONS

Q 1: Discuss the audit procedures adopted for audit of accounts of a charitable institution.

Q 2: Explain the special points to be noted in the audit of the accounts of a club.

Q 3: Write a short note on audit procedure regarding an audit of Hotels.

Q 4: What are the special areas which are needed to be observed in an audit of educational institutions?

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UNIT 12: DEPRECIATION

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Concept of Depreciation

12.4 Causes of Depreciation

12.5 Importance of Providing Depreciation

12.6 Distinction Between Fluctuation and Depreciation

12.7 Methods of Depreciation

12.8 Factors Determining Extent of Depreciation

12.9 Legal Provisions and Commercial Considerations Regarding Depreciation

12.10 Auditor's Duty Regarding Depreciation

12.11 Let Us Sum Up

12.12 Further Readings

12.13 Answers to Check Your Progress

12.14 Model Questions

12.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- discuss the concept of depreciation and the causes thereof
- explain the importance of providing depreciation
- differentiate between fluctuations and depreciation
- explain the methods of depreciation and the factors determining extent of depreciation
- understand the legal provisions and commercial considerations regarding depreciation
- discuss the Auditor's duty regarding depreciation.

12.2 INTRODUCTION

Depreciation is one of the most critical concepts of accounting. Being a non-cash item, depreciation may be used to manipulate accounting process. One should understand calculation and accounting treatment of depreciation to deal with the practical situation. Further, correct calculation of depreciation and thus, the valuation of fixed assets is very necessary for arriving at a true and fair view of financial statements.

12.3 CONCEPT OF DEPRECIATION

Any organisation is established with the intention of carrying on business for indefinite period. In the process, fixed assets are acquired for use in the business which increases the profit earning capacity of the business. The fixed assets due to their constant use gradually lose their value. The effectiveness of assets also goes on decreasing with the passage of time. This 'wear and tear' or loss in the value and utility of assets due to their constant use and expiry of time is termed as depreciation in accounting.

According to Accounting Standard, "Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, and obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose usefulness is predetermined".

Thus, depreciation can be featured with the following points:

- Depreciation is loss in the value of assets.
- The loss is gradual and constant.
- Depreciation is the exhaustion of effective life of the asset.
- Maintenance of assets cannot be treated as depreciation.
- It is continuing decrease in the value of assets.
- It is the allocation of cost of assets to the period of its life.

12.4 CAUSES OF DEPRECIATION

From the above definition and meaning of depreciation, it is evident that depreciation may be caused by any of the following factors:

1. **Constant use**: The most common cause of depreciation of assets is its constant use. The use of the assets leads to the loss in the value, efficiency and utility of fixed assets which is termed as depreciation.
2. **Expiry of time**: Another very common cause of depreciation is passage of time. The effective life of an asset goes on decreasing with the expiry of time.
3. **Obsolescence**: Due to the new inventions, improved techniques and technological advancements, the old assets will become obsolete. For instance, with the invention of computer the old typewriter has become obsolete.
4. **Permanent fall in price**: Sometimes the loss in the value of assets may be caused due to permanent fall in the value of the investments. Though fluctuations in the market value of fixed assets is not recorded in the books, but loss due to permanent fall in the market value needs to be recorded.
5. **Depletion:** Loss of mineral wealth due to constant working of mines is also depreciation, but termed as 'depletion'. For instance, a particular mine has got 10,000 tons of coal during the 1st year, coal worth 5,000 tons have been extracted. The loss of 5,000 tons of coal from mines is loss due to depletion.
6. **Abnormal factors**: Depreciation may also be due to the loss in the value of assets by accidents and damage.

   Depreciation in the value of assets in all the above cases is accounted for in the books of accounts.

Depreciation		
Causes	**Need**	**Factors**
Constant use	determination of net profit	Total cost of the assets
Expiry of times	for showing assets at fair and true value in the balance sheet	
Obsolescence	Provision of funds for replacement of assets	Estimated useful life of assets
Depletion	Ascertaining accurate cost of production	
Permanent fall in price	Distribution of dividend out of profit only	Estimated scrap value
Abnormal factor	Avoiding over payment of income tax	

Some important points:

- *Land and building is never depreciated instead it is always appreciated.*
- *Depreciation is charged every year whether the company is even suffering from losses.*



CHECK YOUR PROGRESS

Q 1: Define depreciation.

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Q 2: Mention two features of depreciation.

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Q 3: State two causes of depreciation.

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12.5 IMPORTANCE OF PROVIDING DEPRECIATION

Importance or need of providing depreciation in the books of accounts may be listed as follows:

a) **Provision of funds for replacement of assets:** With the gradual decrease in the value of the fixed assets acquired and used in the business becomes valueless/useless on expiry of estimated life or even before that. Such asset needs to be replaced with another new asset which requires funds. Proper provision of depreciation can make the funds available for purchase of the new asset. Further, proper provision of depreciation helps to keep the capital intact.

b) **Determination of net profit or net loss:** The ultimate objective of accounting is to ascertain the correct net income of the business. To achieve this objective, expenses needs to be treated correctly. For correct presentation of expenses, depreciation must be accounted for in the debit side of the profit and loss account as a charge over the revenue. Proper calculation of depreciation is essential to determine the correct net profit and net loss of the business.

c) **Presentation of true and fair view of assets in the balance sheet:** The proper charge of depreciation on fixed assets is essential to ascertain the true ad correct value of the fixed assets. If depreciation is not charged then the asset will show a value more than its actual value in the balance sheet and the financial statement will fail to give a true and fair view of the business.

d) **Ascertainment of accurate cost of production:** Depreciation is a must charge on the revenue of the business. It increases the cost of production and thus the price of the goods will be fixed at a higher rate. But if the depreciation is ignored, the cost of production will be calculated at a lower value and thus the sales price will also be lower. This will reduce the margin of profits.

e) **Avoiding over payment of income tax:** In the absence of depreciation, the profit and loss account will show more profit. Thus, more income tax will have to be paid than what it should have actually

been. The profit will reduce with the amount of depreciation, so lesser or the actual income tax will be paid. Hence, depreciation avoids over payment of income tax.

f) **Distribution of dividend:** Dividend is distributed out of the profits shown in the profit and loss account. Unless the depreciation is charged out of the profit and loss account, it will show higher profits which may result in excess distribution of dividends to the shareholders and the capital may flow out. Charging depreciation in the profit and loss account gives the accurate net profit and thus, dividend will be paid out only from profit.

Such factors make the provision of depreciation indispensable for proper accounting.

12.6 DISTINCTION BETWEEN FLUCTUATION AND DEPRECIATION

Depreciation should not be confused with any fluctuation in the value of fixed asset. Increase and decrease in the market value of assets is known as 'fluctuation'. As we record the value of these assets on historical basis, we do not pass any entry for the fluctuations in the market value of the assets. In case of permanent fall in the value of investments, fluctuation may be recorded. The market price of an asset at the end of a year may be either more or less than its book value. This happens due to the rise or fall in the price level, a factor over which the business has no control. Such fluctuation in the value of assets may or may not be taken into account, for fixing the sale price of the articles manufactured, but these are generally ignored for computing the amount of depreciation chargeable to the Profit and Loss Account.

Basis of Distinction	Fluctuation	Depreciation
1. Meaning	Increase and decrease in the market value of assets	Loss in the value of asset due to constant use or expiry of time
2. Phenomena	Fluctuation is a temporary variation in the price of an asset	Depreciation is permanent fall in the value of an asset
3. Nature	Fluctuation is neither continuing nor gradual. It happens all of a sudden.	Depreciation is continuing and gradual in nature.
4. Based on	Fluctuation is concerned with market value	Depreciation is calculated on cost price
5. Accounting	Not recorded in the books of accounts.	Charged in the Profit and Loss account as a business expense.
6. Effect on net profit	It does not affect the net profit of the business	It influences the net profit or net loss of the business.

12.7 METHODS OF DEPRECIATION

There are several methods of calculating depreciation. Every method has its own pros and cons. Different methods are suitable for different assets. These methods are listed below:

1. Fixed or Equal installment method or Straight line method.
2. Diminishing or reducing balance method or written down value method.
3. Annuity method.
4. Depreciation fund method.
5. Insurance policy method.
6. Revaluation method.
7. Depletion method.

8. Machine hour rate.
9. Sum of years digit method.
10. Replacement method.

Most commonly used methods of depreciation are Straight – line method and the reducing balance method.

1. **Fixed or Equal installment method or Straight line method:** Under this method, an equal amount is written off each year during the life of the asset. It is the simplest method of charging depreciation. Here, the original cost of the asset is divided by the estimated life of the asset. For example, if the value of asset is Rs. 50,000.00 and its useful life is estimated to be 10 years, then the amount of depreciation to be charged every year will be Rs. 5,000.00 (i.e. Rs 50,000/10). In other words, the amount of depreciation to be charged every year is fixed at Rs. 5,000.00. Sometimes, a scrap or residual value of assets is also given. In such cases, the following formula is used for calculation of depreciation:

$$Annual\ depreciation = \frac{Cost\ of\ the\ asset - Scrap\ value\ or\ salvage\ value}{Estimated\ life\ of\ the\ asset}$$

Where, Cost of the asset means original cost or historical cost of the asset. It includes the cost of acquisition (i.e. carriage, installation charges, construction charges etc.)

Scrap value or salvage value means the amount fetched by scrapped asset at the end of the useful life of the asset. The asset can be disposed off as scrap even after it becomes obsolete or useless on expiry of its useful life. It is also called residual value.

Estimated life of the asset is generally the estimated working life of the asset as mentioned by the manufacturer. If the life of the asset is not mentioned by the manufacturer, it is determined by some scientific method based on past experience.

Under straight line method, depreciation may also be determined by applying a fixed rate to the original cost of the asset.

$$Rate\ of\ Depreciation = \frac{Annual\ Depreciation}{Cost\ of\ the\ Asset} \times 100$$

Advantages of Straight line method:

The advantages of calculating depreciation under straight line method can be listed as follows:

- It is the simplest method of calculating and providing depreciation. Even an ordinary person can understand this method.
- According to this method, the depreciation is calculated on the original cost of the asset at the specified rate, so the value of asset is fully split over the useful life of the asset. Thus the assets can be written off to zero.
- Straight line method of depreciation is ideal for small firms because it is easy, simple and suitable to the size of the firms.
- This method of depreciation is most suitable for the assets having lesser value.
- Under this method, the amount of total depreciation charged can be easily found out by multiplying the yearly amount of depreciation with number of years, the asset have been used.

Disadvantages of Straight line method:

Though the method is simple but it is not very scientific. The straight line method comes with the following limitations:

- This method leads to undue pressure in the final years of the life of the asset. The final years of the asset have to bear more repairs and maintenance charges and also the same amount of depreciation, whereas initial years have to suffer lesser repair charges.
- Following this method of depreciation, the firms have to bother for making arrangements for funds for replacement of assets, though the depreciation is charged every year.
- This method is not suitable for larger firms.
- The straight line method of depreciation is also not very suitable for assets having longer useful asset and higher value.

2. Diminishing or Reducing balance or Written down value method:

This method of depreciation is developed to remove the shortcomings of the Straight line method. Under reducing balance method, the annual charge for depreciation decreases from year to year with the result

that earlier years suffer to the benefit of the later years. Also, the value of an asset can never be completely written off under this method. The rate of depreciation applied under this method is substantially higher than the rate used under straight line method. Here, since the value of asset on which the depreciation is to be calculated goes on diminishing, so the amount of depreciation charged every year goes on decreasing. For example, if a machine is acquired at Rs. 50,000.00 and the rate of depreciation is 10%, then the depreciation will be calculated as follows:

1st year on Rs. 50000@ 10%= 10% of 50000= Rs 5,000.00

2nd year on Rs 45000(i.e. Rs 50000- Rs 5000) @ 10%=10% of 45000= Rs. 4,500.00

3rd year on Rs 40500(i.e. Rs 45000- Rs 4500) @ 10%=10% of 40500= Rs. 4,050.00

4th year on Rs 36450(i.e. Rs 40500- Rs 4050) @ 10%=10% of 36450= Rs. 3,650.00

And so on.

Thus it is evident from the example that the balance of the asset upon which keeps diminishing every year and hence the amount of depreciation calculated thereon keeps on declining.

Advantages of Diminishing balance method:

- Depreciation under this method is easier to calculate as compared to other methods of depreciation except Straight line method.
- It is a more logical and scientific method of calculating depreciation, as the value of the depreciable asset goes on diminishing from year to year.
- This method is also very suitable to the assets having longer useful life and those having higher value.
- The reducing balance method is also beneficial for income tax purposes as this method is approved by the tax authorities.
- Further, the amount of depreciation calculated under this method helps in keeping balanced effect on the profit and loss account over different years as the amount of depreciation is more in the initial years and

lesser in the later years while the maintenance charges are less in the initial years and increases in the later years. Hence this keeps the burden of depreciation and maintenance expenses balanced on the profit and loss account over the different years.

Disadvantages of Diminishing balance method:

- One of the main disadvantages of this method is that the value of the asset cannot be reduced to zero, even if the asset becomes useless.
- Diminishing balance method is not suitable for the assets having lower value or lesser number of useful years of life.
- The method is also not very ideal to be adopted by smaller firms.
- Rate of depreciation is much higher under this method, because it will require longer period to write off the asset, if the rate is kept lower and the asset may become useless earlier.

Besides, there are other methods of calculating depreciation which are not much used. The following important factors are taken into account by the management while selecting a particular method of calculating depreciation:

a) Type of asset;
b) The nature of the use of such asset;
c) Circumstances prevailing in the business; and
d) State of the economy – whether stable or inflationary

In a stable economic condition, a business with steady operations may select straight line method. Again certain assets like patents and trademarks should be depreciated on a straight line method because their life is legally prescribed. While a business with uneven asset acquisition over the years may go for diminishing balance method.

Further, as per Accounting Standard 6, the selected depreciation method should be applied consistently from period to period. Change in the method of depreciation may be allowed only under special circumstances. The businesses are required to follow consistency in the method of depreciation over the years to facilitate comparability of financial results of different years. The adoption of new method from existing method of depreciation is allowed only if it is required under statute or for compliance

of accounting standard or for better presentation of financial statements. In such cases, the depreciation of the earlier years needs to be recalculated according to the new method to give a retrospective effect on profit and loss account.



CHECK YOUR PROGRESS

Q 4: State two importance of providing depreciation.

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Q 5: Mention two commonly used methods of depreciation.

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Q 6: State two advantages of diminishing method of depreciation.

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12.8 FACTORS DETERMINING EXTENT OF DEPRECIATION

Following factors are usually considered for determination of depreciation and the amount to be charged thereof in an accounting period:

a) **Historical cost.** Historical cost is usually the original cost of the asset at which it is acquired. Sometimes the historical cost is the cost substituted on revaluation of the depreciable asset. This cost also includes the expenses incurred in acquiring the asset (i.e. carriage, installation charges, construction charges etc.).

b) **Expected life of the asset.** The useful life of a depreciable asset may be shorter than its physical life. It is a matter of estimation normally based on the past experience with similar types of assets. Following are the factors to determine the useful life of the depreciable asset:

i. Pre-determined by legal or contractual limits, e.g. expiry dates of leases.

ii. Governed by extraction or consumption.

iii. Dependent on the extent of use and physical deterioration due to wear and tear, which again depends on the operational factors.

iv. Reduced by obsolescence arising from such factors like technological changes, improvement in production methods, change in market demand, legal or other restrictions etc.

c) Scrap or Residual or Salvage value of the asset. The amount fetched by the sale of scrapped asset, even after the expiry of the useful life of asset is termed as Scrap or Residual or Salvage value.

The quantum of depreciation to be provided in an accounting period involves the exercise of judgment by management in light of the technical, commercial, accounting and legal requirements and accordingly may need periodic review.

12.9 LEGAL PROVISIONS AND COMMERCIAL CONSIDERATIONS REGARDING DEPRECIATION

Clause 3 (iv) of Part II to Schedule VI to Companies Act, 1956 mandates to disclose the amount of depreciation, renewals or diminution in value of the fixed assets in the Profit and Loss Account. If such a provision is not made by means of a depreciation charge, the method adopted for making such a provision should be disclosed. If no provision has been made for depreciation in respect of a particular asset, the fact that no provision has been made should be stated and the quantum of arrears of depreciation computed in accordance with Section 205(2) should be disclosed by way of a note. The Balance Sheet prescribed under Part I of Schedule VI of the Companies Act, 1956 also requires that the total depreciation written off or provided in respect of each asset should be disclosed.

On account of the provision under section 205 that, no dividend shall be declared except out of profits arrived at after providing for depreciation in accordance with the provisions of the Act, it has become obligatory for every company distributing dividend to make a provision for depreciation. Sub-section (2) of Section 205 prescribes different methods that may be adopted for computing the amount of depreciation.

As per new Companies Act, 2013, following are the provisions to be taken care of regarding depreciation:

1. Schedule II of the Companies Act 2013 for calculating depreciation is applicable only on tangible assets. For calculating Depreciation on intangible assets, the companies have to follow the applicable accounting standards.
2. Depreciation as per Companies Act 2013 depends on the useful life of various assets as defined in the Schedule II to the Companies Act 2013
3. Rates of depreciation depend on the useful life of assets. No separate rates of depreciation are defined in the Act.
4. 95% of the original cost of the asset has to be depreciated
5. 5% is the residual value of assets prescribed as per schedule II of the Companies Act 2013. The residual value of asset is to be calculated on the original cost of the Asset
6. The useful life of various assets as given in schedule II is mandatory to be followed. If a Company does not follow such useful life then it has to submit a technical report substantiating the useful life taken by it. Also, a disclosure mentioning a different useful life to that prescribed in the Act is used by the Company is mandatory
7. Date of purchase is most important to calculate the remaining useful life of the asset as on 01.04.2014. Existing assets are to be depreciated over the remaining useful lives as on 01.04.2014. Date of purchase can be found in the fixed asset register or the depreciation chart of the company and can also be available in the tax audit report of the Company for various years
8. If the life of the asset as on 01.04.2014 is already more than useful life as prescribed in Schedule II, then no depreciation can be charged after 01.04.2014. However, an amount equal to the (WDV-Residual value) has to be written off from either the P&L A/c or from the retained earnings of the Company in the FY 2014-15
9. During the transitional year i.e. FY 2014-15, The Company cannot change its method of calculating depreciation from WDV to SLM or vice-versa.

Any change by the company in the method of calculating depreciation will amount to change in accounting policy as per AS-5. The calculation of the impact of such change on the Statement of Profit & Loss has to be disclosed by the company in its financial statements

10. The rate of depreciation becomes 1.5 times & 2 times of the normal rates in case of double shifts and triple shifts respectively
11. Charging depreciation is mandatory if the company wants to declare dividend or for payment of managerial remuneration. Charging depreciation is also mandatory as per the applicable accounting standards in order to give a true & fair view
12. As per ICAI guidance note, if the value of the asset is up to Rs. 5000/ - then it can be fully depreciated

12.10 AUDITOR'S DUTY REGARDING DEPRECIATION

Apart from fixed assets in respect of which depreciation must be provided, it also has to be provided on semi permanent assets like patents, trademarks etc. the auditor cannot be held responsible for estimating the working life of an asset. He has to rely on the opinion of the persons who have technical knowledge of the assets. However, he must satisfy himself-

- that an honest attempt has been made to estimate the working life of each asset,
- that the total provision for depreciation is adequate, and
- that the method adopted for determining that amount to be written off appears to be fair and reasonable.

If he is of the opinion that the provision for depreciation is not adequate, he should report to the appropriate authority. He must also see that the depreciation written off is properly disclosed in the profit and loss account and the balance sheet. The auditor must also consider the following points regarding depreciation:

- A company can adopt different methods for different types of assets provided the methods are adopted consistently over the years
- If a company opts to choose new depreciation methods, the

depreciation should be recalculated from the date of first use of the asset and accounted for in the profit and loss account.

- According to schedule ii of the companies act, if asset is sold or discarded during the year, depreciation will be charged on pro rata basis upto the date of sale or discard.
- Accounts must disclose the method of depreciation
- Depreciation must be according to the provisions of Companies Act and Income Tax Act.
- If depreciating is charged more than prescribed rate, auditor should examine whether it is based on some professional and technical advice
- Depreciation should be charged on revalued amount if there is revaluation of assets.



CHECK YOUR PROGRESS

Q 7: Mention two factors considered for determination of depreciation..

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12.11 LET US SUM UP

In this unit we have discussed the following points regarding depreciation:

- Loss in the value of an asset due to each constant use and expiry of time is termed as depreciation.
- **Causes of Depreciation:** Constant use; Passage of time; Depletion; Obsolescence; Permanent fall in price; Abnormal factors.
- **Importance of Depreciation:** for determination of correct net profit or net loss; for showing true and fair view of the balance sheet; provision of funds for replacement of assets; ascertaining accurate cost of

production; distribution of dividend out of profit only; avoiding over payment of income tax.

- **Methods of Calculating depreciation:** Two widely used methods of calculating depreciation are: Straight line method and Diminishing balance method.
- **Factors determining the extent of depreciation:** Total cost of the assets; estimated useful life of the assets; estimated scrap value.
- Disclosure of depreciation and method of calculating thereof is mandatory in the books of accounts.
- **Auditors Duty regarding depreciation:** To satisfy himself regarding the estimated working life of the assets; provision for depreciation is adequate and the method of depreciation is fair and reasonable, verify that the depreciation written off is disclosed in the Profit and Loss Account and Balance Sheet.



12.12 FURTHER READINGS

1) Basu S. K. (2008). *Auditing : Principles and techniques*, New Delhi, Pearson Education Ltd.
2) Gupta K. (2005). *Contemporary Auditing*. New Delhi, Tata McGraw Hills.
3) Kumar R. & Sharma V. (2005). *Auditing : Principles and Practice*. New Delhi, Prentice Hall of India Pvt. Ltd.
4) Saxena R. G. (2001). *Principles and practice of Auditing*. New Delhi, Himalaya Publishing House.
5) Tandon B.N., Sudharsanam S. & Sundhprabha S. (2010). *A handbook of practical auditing*. New Delhi, S. Chand & Co. Ltd.

12.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: According to Accounting Standard, "Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time, and obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose usefulness is predetermined".

Ans to Q No 2: a) Depreciation is loss in the value of assets.

b) The loss is gradual and constant.

Ans to Q No 3: a) Constant Use

b) Expiry of Time

Ans to Q No 4: a) Provision of funds for replacement of assets

b) Determination of net profit or net loss

Ans to Q No 5: a) Straight Line Method

b) Diminishing Balance Method

Ans to Q No 6: a) Depreciation under this method is easier to calculate as compared to other methods of depreciation except Straight line method.

b) It is a more logical and scientific method of calculating depreciation, as the value of the depreciable asset goes on diminishing from year to year.

Ans to Q No 7: a) Total cost of the assets;

b) estimated useful life of the assets



12.14 MODEL QUESTIONS

Q 1: Explain the concept of depreciation. What is the need of charging depreciation and what are the causes of depreciation?

Q 2: Distinguish between fluctuation and depreciation.

Q 3: Describe in detail two methods of recording depreciation.

Q 4: Explain the determinants of extent of depreciation.

Q 5: What are the advantages and disadvantages of straight line method and written down value method of depreciation?

Q 6: Discuss the Auditors duty regarding depreciation.

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UNIT 13 RESERVE

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Meaning and Definition

13.4 Classification of Reserves

13.5 Distinction Between Reserves and Provisions

13.6 Auditor's Duty Regarding Reserves

13.7 Distinction Between Capital Reserve and Reserve Capital

13.8 Secret Reserve

13.9 Let Us Sum Up

13.10 Further Readings

13.11 Answers to Check Your Progress

13.12 Model Questions

13.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning of reserves
- understand the various classification of reserves
- distinguish between reserves and provisions
- understand auditor's duty regarding reserves
- distinguish between capital reserve and reserve capital

13.2 INTRODUCTION

It is usually unknown that a business will run smoothly throughout its life. Uneven situations may arise in a business suddenly. As such, keeping aside some portion of the current profits for such unhealthy situations is a good practice for the business. This act of setting aside a portion of earnings for some specific or general purpose is understood as creation of reserves

or transfer to reserves. In this chapter, we shall discuss the various kinds of reserves created by the business organisations. We shall also understand the difference between reserves and provisions; reserve capital and capital reserve. Further, we shall also discuss Auditor's Duty regarding the audit of reserves and surplus.

13.3 MEANING AND DEFINITION

Reserves are appropriation out of profits, receipts or other surpluses of an enterprise created or transferred by the management for a general or specific purpose but not for meeting any liability, contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet. Reserves are created to strengthen the financial position of the business. It is not a charge against profit as it is not meant to cover any known liability or expected loss in future. Since reserves are created only out of profits, it reduces the amount of profits available for distribution among the shareholders of the business. Reserves should be distinguished from provisions. A reserve is an appropriation of profit for a specific purpose, while a provision is a charge for an estimated expense.

The Ministry of Corporate Affairs on 6 April 2016, amended Schedule III to include general instructions for preparation of financial statements and additional disclosure requirements for companies whose financial statements are required to comply with Ind AS. As per the revised Schedule III, a company is required to disclose its reserves under the head Other Equity" in a newly introduced component of financial statement called "Statement of Changes in Equity". As such, reserves shall not be directly disclosed in the face of the Balance Sheet, but its balances shall be reflected under the head "Other Equity" along with other non-reserve items.

Eric L. Kohler defines a reserve as *"A segregation or earmarking of retained earnings evidenced by the creation of a subordinate account..... The earmarking may be temporary or permanent, the purpose being to indicate to stock holders and creditors that a portion of surplus is recognized as available for dividends".*

The ICAI defines the term "reserves" as *"the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for known liability".*

13.4 CLASSIFICATION OF RESERVES

Schedule III of the Companies Act, 2013 classifies "Reserves" as

i) Capital Reserve: When reserve is created out of capital profits, it is called "Capital Reserve". Such reserves do not arise from normal operating activities and they are also not available for distribution to shareholders as dividend. As per the Guidance Note on Terms Used in Financial Statements, issued by ICAI, Capital Reserves is defined as "a reserve of a corporate enterprise which is not available for distribution as dividend".

Capital Reserves can be utilised by a business for some specific purposes as per the requirement of law e.g. to write off capital losses or issue of bonus shares. A few examples of capital profits out of which Capital Reserve is created are:

a) Profits prior to incorporation
b) Profit on sale of fixed assets
c) Profit on reissue of forfeited shares.

ii) Capital Redemption Reserve: As per the provisions of the Companies Act, 2013, Capital Redemption Reserve is required to be created in the following circumstances:

i) Where a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet.

ii) Where a company proposes to redeem its preference shares out of the profits of the company, there shall, out of such profits,

be transferred, a sum equal to the nominal amount of the shares to be redeemed, to a reserve, to be called the Capital Redemption Reserve Account.

The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

iii) **Securities Premium Reserve:** It is an account created by a company to transfer its balance of securities premium amount received on issue of shares. According to Companies Act, 2013, where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account". According to Sec 52 of the Companies Act, 2013, Securities Premium Account may be utilised by the Company:

(a) towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares;

(b) in writing off the preliminary expenses of the company;

(c) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

(d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or

(e) for the purchase of its own shares or other securities under section 68.

iv) **Debenture Redemption Reserve:** Section 71(4) of the Companies Act, 2013 states that where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilised by the company except for the redemption of debentures. Rule 18(7) of the Companies (Share

Capital and Debentures) Rules, 2014 prescribes conditions for creation of Debenture Redemption Reserve. Creation of Debenture Redemption Reserve would ensure that the company will have adequate funds for redemption of debentures when they become due.

v) **Revaluation Reserve:** Revaluation Reserve is created by the company if the carrying amount of an asset is increased on revaluation. A company needs to revalue its assets at sufficient regularity so that the carrying amount of the assets does not differ materially from that which would be determined using fair value at the Balance Sheet date. When a fixed asset is revalued, any increase in the carrying amount of the asset is credited to Revaluation Reserve. Revaluation Reserve shall be disclosed in the Balance Sheet as Revaluation Surplus under the head Other Equity on the face of the Balance Sheet.

vi) **Share Option Outstanding Account:** It is an account created by a company when it receives services in an equity settled employee share based payment plan. It is created to recognize the services as an expense with a corresponding credit to the 'Share Option Outstanding Account'

vii) **Other Reserves:** Reserves created by the company other than those mentioned above shall be recorded in the financial statements as 'Other Reserves'. However the nature, purpose and the amount of such reserves should be shown separately.



CHECK YOUR PROGRESS

Q 1: Define Reserves.

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.....

Q 2: What is meant by Share Option Outstanding Account.

.....

.....

13.5 DISTINCTION BETWEEN RESERVES AND PROVISIONS

Basis of Difference	Provision	Reserve
Nature	Provisions are charges against profits.	Reserves are an appropriation of profits.
Profit Dependency	Creation of provision does not depend on profit.	In the absence of adequate profits, reserves cannot be created.
Purpose	Provisions are created to meet known liability.	Reserves are created for strengthening the financial position of the business. It has no effect on taxable profits.
Effects on taxable profits Disclosure in Balance Sheet	It reduces taxable profits. Provisions are disclosed on the face of the Balance Sheet under "Other Current Liabilities'.	Reserves are disclosed in the Balance Sheet under "Other Equity".
Requirement as per Law.	Creation of provision is legally necessary	Reserves are created as per financial prudence.
Types	Provision for depreciation, Provision for bad and doubtful debts, Provision for taxation etc.	Capital Reserve, Securities Premium Reserve, Capital Redemption Reserve etc.
Distribution as dividend	It cannot be used for dividend distribution	It can be used for dividend distribution

13.6 AUDITOR'S DUTY REGARDING RESERVES

In a business organisation, normally there are very few transactions relating to Reserves during a financial year. But the significance of those transactions is very high in terms of materiality and hence requires careful observation by the Auditor.

An auditor may verify the reserves of a company employing the following procedures:

(i) Examination of records;

(ii) Examination of compliance with laws and regulations and terms of issue/contract, if any; and

(iii) Examination of presentation and disclosure

A few of the important areas which an auditor needs to consider while verifying reserves are as follows:

1. The auditor should verify that the reserves are disclosed in the financial statements are per the provisions of the Companies Act, 2013.
2. The auditor should verify the minutes of the board meetings and ensure that the profits are appropriated as per the decision taken by the directors.
3. The auditor should ensure that appropriation of profits to general or special reserves are as per the requirements of Articles of Association of the company.
4. 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.
5. 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.
6. The auditor should also ensure that the reserves are utilized only for the purpose for which they are created.

13.7 DISTINCTION BETWEEN CAPITAL RESERVE AND RESERVE CAPITAL

Basis of Difference	Capital Reserve	Reserve Capital
1 Meaning	Capital Reserves are profits appropriated out of capital profits which do not arise from the normal operating activities.	Reserve Capital is that part of Uncalled capital which can be called up only when the company goes into liquidation.
2. Creation source	Created out of Capital Profits only.	Part of Uncalled Capital created out of Authorised Capital.
3. Special Resolution	No need of passing any special resolution for creating capital reserve.	Creation of Reserve Capital needs a Special Resolution.
4. Utilisation	It can utilised to write off fictitious assets or capital losses etc.	It can be called and utilised at the time of winding up of the company.
5. Disclosure in Balance Sheet	On the Equity and Liabilities side of the Balance Sheet under the head "Other Equity"	Not disclosed in the Balance Sheet.
6. Requirement as per Law.	Creation of Capital Reserves is mandatory due to compliance of legal requirements or accounting practices	It is not mandatory for a company to create Reserve Capital.



CHECK YOUR PROGRESS

Q 3: State two differences between reserves and provisions.

.....

.....

Q 4: State two differences between reserve capital and capital reserve.

.....

13.8 SECRET RESERVE

Secret Reserves are those reserves which do not appear on the Balance Sheet of a Company. According to the Provisions of the Companies Act, 2013, companies are prohibited from creating Secret Reserves except in the case of banking, financial, insurance and electricity companies.

A company may create secret reserves by-

1) Overvaluing the liabilities in the Balance Sheet.
2) Providing excessive depreciation.
3) Creating or providing more reserve for doubtful debts.
4) Bringing down the value of the assets much below their cost.
5) Writing off goodwill.
6) Charging capital expenditure to revenue account.
7) Omitting certain assets from the Balance Sheet.
8) Disclosing contingent liabilities as current liabilities/provisions in the Balance Sheet

Identifying secret reserves requires due diligence and careful observation by the auditor. Since creation of Secret Reserves is prohibited under Companies Act, 2013, the auditor has to verify that no secret reserves are maintained by the companies.



13.9 LET US SUM UP

In this unit, we have discussed the following aspects:

- The act of setting aside a portion of earnings for some specific or general purpose is understood as creation of reserves or transfer to reserves.
- Reserves are appropriation out of profits, receipts or other surpluses of an enterprise created or transferred by the management for a general or specific purpose but not for meeting any liability,

contingency, commitment or diminution in the value of assets known to exist as at the date of the Balance Sheet.

- Reserves are created to strengthen the financial position of the business. provisions.
- A reserve is an appropriation of profit for a specific purpose, while a provision is a charge for an estimated expense.
- Schedule III of the Companies Act, 2013 classifies "Reserves" as
  i) Capital Reserves
  ii) Capital Redemption Reserve
  iii) Securities Premium
  iv) Debenture Redemption Reserve
  v) Revaluation Reserve
  vi) Share Option Outstanding Account
  vii) Other Reserves
- Secret Reserves are those reserves which do not appear on the Balance Sheet of a Company. According to the Provisions of the Companies Act, 2013, companies are prohibited from creating Secret Reserves except in the case of banking, financial, insurance and electricity companies.



13.10 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.
2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.
3) Saxena R. G. (2001). Principles and practice of Auditing, New Delhi, Himalaya Publishing House.
4) ICAI (2016). Advanced Auditing and Professional Ethics, Study Material, ICAI, New Delhi.

13.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Eric L. Kohler defines a reserve as *"A segregation or earmarking of retained earnings evidenced by the creation of a subordinate account..... The earmarking may be temporary or permanent, the purpose being to indicate to stock holders and creditors that a portion of surplus is recognized as available for dividends".*

Ans to Q No 2: It is an account created by a company when it receives services in an equity settled employee share based payment plan. It is created to recognize the services as an expense with a corresponding credit to the 'Share Option Outstanding Account'

Ans to Q No 3: Two differences between Provisions and Reserves are as follows:

i) Provisions are charges against profits while Reserves are an appropriation of profits.

ii) Creation of provision does not depend on profit where as reserves cannot be created in the absence of adequate profits.

Ans to Q No 4: Two differences between Capital Reserve and Reserve Capital are as follows:

i) Capital Reserves are profits appropriated out of capital profits which do not arise from the normal operating activities. Whereas, Reserve Capital is that part of Uncalled capital called up only when the company goes into liquidation.

ii) Capital Reserve can utilised to write off fictitious assets or capital losses etc. On the other hand, Reserve Capital can be called up and utilised at the time of winding up of the company.



13.12 MODEL QUESTIONS

Q 1: What do you mean by reserves? Classify reserves as per the provisions of Companies Act, 2013.

Q 2: Distinguish between Reserves and Provisions.

Q 3: Write a note on Auditor's Duty regarding reserves.

Q 4: State the differences between Reserve Capital and Capital Reserve.

Q 5: Write a short note on Secret Reserve.

*** ***** ***

UNIT 14: AUDITOR'S REPORT

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Meaning and Concept of Audit Report

14.4 Provisions of the Companies Act 2013 regarding the Auditor's Report

14.5 Auditor's Report and Standards on Auditing

14.6 Basic Elements of an Audit Report

14.7 Format of Auditor's Report as per the provisions of the Companies Act, 2013.

14.8 Types of Audit Opinion

14.9 Features of good Audit Report

14.10 Let Us Sum Up

14.11 Further Readings

14.12 Answers To Check Your Progress

14.13 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, you will be able to:

- explain the meaning and purpose of Audit Report
- discuss the provisions of Companies Act, 2013 regarding the Auditor's report
- explain the basic elements of Audit Report
- discuss the format of Auditor's Report
- explain the features of a good audit report.

14.2 INTRODUCTION

As soon as an Auditor completes his auditing field work, he is required to prepare a report expressing his views and opinion on the truth and fairness of the financial statements of an organisation. The Auditor needs to be very

careful, vigilant and objective in the matter relating to preparation of audit report because a large number of stakeholders rely on such report on the financial statements of an organisation. The auditor should take every possible measure to ensure that the financial statements reflect a true and fair picture of affairs of the company. In this unit, we are going to discuss about the auditor's report on financial statements, its features, types, significance and various other matters relating to preparation of an Audit report.

14.3 MEANING AND CONCEPT OF AUDIT REPORT

Every year, a business reports its profits or losses during the year and states its financial position at the end of the year in the form of Statement of Profit & Loss and Balance Sheet respectively. The responsibility of preparation of financial statements is upon the management of the company. In order to assure the truth and fairness of the financial statements, every company shall appoint an Auditor every year to express his views and opinions on the truth and fairness of the financial statements prepared by the management. The report prepared by the auditor is called Audit Report or Auditor's Report. It is very important to note that an Auditor's Report on financial statements is not an evaluation or assessment of the figures or items disclosed in the financial statements. It is only an opinion on the truth and fairness of the financial statements prepared by the management of the company. The main users of the audit report are shareholders, members and all other stakeholders of the Company.

14.4 PROVISIONS OF THE COMPANIES ACT 2013 REGARDING THE AUDITOR'S REPORT

As per the provisions of the Companies Act, 2013, the auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or

under any order made under sub-section (*11*) and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed.

Further, the auditor's report shall also state—

(*a*) whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(*b*) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(*c*) whether the report on the accounts of any branch office of the company audited under sub-section (*8*) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(*d*) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(*e*) whether, in his opinion, the financial statements comply with the accounting standards;

(*f*) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(*g*) whether any director is disqualified from being appointed as a director under sub-section (*2*) of section 164;

(*h*) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(*i*) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(*j*) Where any of the matters required to be included in the audit report under this section is answered in the negative or with a qualification, the report shall state the reasons there for.



CHECK YOUR PROGRESS

Q 1: What is meant by Audit Report?

.....

Q 2: Who is responsible for preparation of financial statements of a Company?

.....

14.5 AUDITOR'S REPORT AND STANDARDS ON AUDITING

The ICAI in co-ordination with Auditing and Assurance Standard Board (AASB) has issued certain Standards on Auditing (SAs) to provide guidance to auditors while performing an audit and issuing a report thereafter. The Standard on Auditing (SA) 700, "Forming An Opinion And Reporting On Financial Statements" deals with the form and content of the auditor's report on the truth and fairness of financial statements. According to SA 700 (Revised), the objectives of the auditor are:

a) to form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

b) to express clearly that opinion through a written report.

SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report" deals with the auditor's responsibility to communicate key audit matters in the auditor's report. SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report. These SAs are formulated to fulfil the need for consistency and comparability in reporting practice of the auditor.

14.6 BASIC ELEMENTS OF AN AUDIT REPORT

i) **Title:** The auditor's report shall have a title clearly mentioning that it is the report of an independent auditor.

ii) **Addressee:** The auditor's report should be addressed properly to those for whom the report has been prepared. Generally, audit report is addressed to the members of the company whose financial statements are being audited.

iii) **Responsibilities for the Financial Statements:** The auditor in his report should include a section wherein he should mention that the management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements as per the provisions of the Companies Act, 2013.

iv) **Auditor's Responsibility:** Herein the auditor shall mention various factors, scope, areas etc. regarding his responsibilities for the Audit of the Financial Statements

v) **Auditor's Opinion:** In this section, the auditor shall express his views and opinion on the truth and fairness of the financial statements prepared by the management.

vi) **Signature of the Auditor:** The Auditor's report should be signed by the auditor in his personal name. Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm.

vii) **Auditor's Address:** The auditor in his report shall mention the name of the city where the audit report is signed.

viii) **Date of the Auditor's Report:** The auditor's report shall be duly dated.

14.7 FORMAT OF AUDITOR'S REPORT AS PER THE PROVISIONS OF THE COMPANIES ACT, 2013

The AASB has issued certain illustrative formats of the Independent Auditor's Report on the Standalone Financial Statements under the Companies Act, 2013. Following is one of such illustrative format issued by AASB.

Circumstances assumed for the illustrative audit report format:

- Audit of a complete set of standalone general purpose financial statements of a company prepared under the Companies Act, 2013 financial reporting framework.
- The terms of audit engagement reflect description of management's responsibility for the financial statements in SA 210, Agreeing the Terms of Audit Engagement.
- The independent auditor:
  a) Has given an ***Unmodified Opinion*** in respect of true and fair view of the financial statements; and
  b) Has given ***Emphasis of Matter*** paragraphs in respect of:-
     - A lawsuit against the Company, the result of which is uncertain.
     - A "material uncertainty" relating to going concern which has been adequately disclosed in the notes to the financial statements.
- In addition to expressing opinion on the true and fair view of the financial statements, ***the auditor has other reporting responsibilities required under the Companies Act 2013 and/or other regulatory requirements, including the responsibility to report on internal financial controls pursuant to section 143(3)(i) of the Companies Act 2013.***

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF ABC COMPANY LIMITED

Report on the Standalone Financial Statements

We have audited the accompanying standalone financial statements of **ABC COMPANY LIMITED** ("the Company"), which comprise the Balance Sheet as at 31st March, 20XX, the Statement of Profit and Loss, the Cash Flow Statement for the year then ended, and a summary of the significant accounting policies and other explanatory information.

Management's Responsibility for the Standalone Financial Statements

The Company's Board of Directors is responsible for the matters stated in Section 134(5) of the Companies Act, 2013 ("the Act") with respect to the preparation of these standalone financial statements that give a true and fair view of the financial position, financial performance and cash flows

of the Company in accordance with the accounting principles generally accepted in India, including the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014. This responsibility also includes maintenance of adequate accounting records in accordance with the provisions of the Act for safeguarding of the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgments and estimates that are reasonable and prudent; and design, implementation and maintenance of adequate internal financial controls, that were operating effectively for ensuring the accuracy and completeness of the accounting records, relevant to the preparation and presentation of the financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these standalone financial statements based on our audit.

We have taken into account the provisions of the Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of the Act and the Rules made there under.

We conducted our audit in accordance with the Standards on Auditing specified under Section 143(10) of the Act. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and the disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal financial control relevant to the Company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of the accounting policies used and the reasonableness

of the accounting estimates made by the Company's Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion on the standalone financial statements.

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

Emphasis of Matters

We draw attention to the following matters in the Notes to the financial statements:

a) Note X to the financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.

b) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully / substantially eroded, the Company has incurred a net loss/net cash loss during the current and previous year(s) and, the Company's current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

Our opinion is not modified in respect of these matters.

Other Matter

We did not audit the financial statements/information of ..... (number) branches included in the standalone financial statements of the Company whose financial statements / financial information reflect total

assets of Rs. ..... as at 31st March, 20XX and total revenues of Rs. ..... for the year ended on that date, as considered in the standalone financial statements. The financial statements/information of these branches have been audited by the branch auditors whose reports have been furnished to us, and our opinion in so far as it relates to the amounts and disclosures included in respect of these branches, is based solely on the report of such branch auditors.

Our opinion is not modified in respect of this matter.

Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

(a) We have sought and obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit.

(b) In our opinion, proper books of account as required by law have been kept by the Company so far as it appears from our examination of those books.

(c) The Balance Sheet, the Statement of Profit and Loss, and the Cash Flow Statement dealt with by this Report are in agreement with the books of account.

(d) In our opinion, the aforesaid standalone financial statements comply with the Accounting Standards specified under Section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014.

(e) The going concern matter described in sub-paragraph (b) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

(f) On the basis of the written representations received from the directors as on 31st March, 20XX taken on record by the Board of Directors, none of the directors is disqualified as on 31st March, 20XX from being appointed as a director in terms of Section 164 (2) of the Act.

(g) With respect to the adequacy of the internal financial controls over financial reporting of the Company and the operating effectiveness of such controls, refer to our separate Report in "Annexure A".

(h) With respect to the other matters to be included in the Auditor's Report in accordance with Rule 11 of the Companies (Audit and Auditors) Rules, 2014, in our opinion and to the best of our information and according to the explanations given to us:

i) The Company has disclosed the impact of pending litigations on its financial position in its financial statements - Refer Note XX to the financial statements; [or the Company does not have any pending litigations which would impact its financial position.]

ii) The Company has made provision, as required under the applicable law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts - Refer Note XX to the financial statements; [or the Company did not have any long-term contracts including derivative contracts for which there were any material foreseeable losses.]

iii) There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company {or, following are the instances of delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company or there were no amounts which were required to be transferred to the Investor Education and Protection Fund by the Company}.

For XYZ & Co
Chartered Accountants
(Firm's Registration No.)
Signature
(Xxxxx X. Xxxx)
(Designation)
(Membership No. XXXXX)

Place of Signature:

Date



CHECK YOUR PROGRESS

Q 3: State any two basic elements of an Audit.

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.....

14.8 TYPES OF AUDIT OPINION

The main objective of an audit work is to express an opinion on truth and fairness of the financial statements prepared by the management. The auditor shall express an unmodified or unqualified opinion when the auditor concludes that the financial statements reflects true and fair position of the company and reported in accordance with the applicable financial reporting framework.

Accordingly, he shall express a modified or qualified opinion in the auditor's report when:

a) The auditor arrives at a conclusion based on the audit evidence obtained that the financial statements as a whole are not free from material misstatement; or

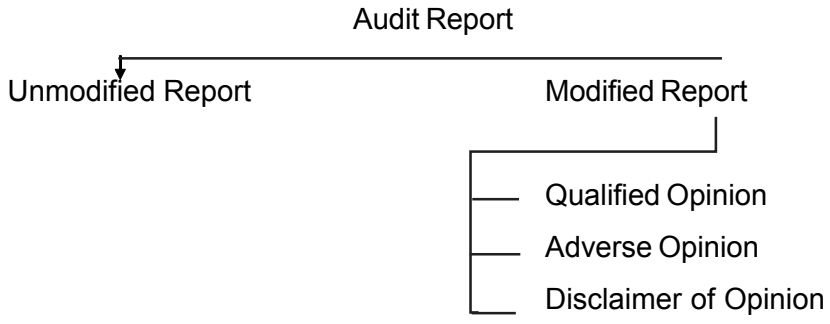
b) The auditor finds self unable to derive sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement.

SA 705 "Modifications To the Opinion In The Independent Auditor's Report" deals with auditor's responsibility to issue an appropriate report in circumstances when, in forming an opinion in accordance with SA 700 (Revised) "Forming An Opinion And Reporting On Financial Statements", the auditor concludes that a modification to the auditor's opinion on the financial statements is necessary. This SA also deals with how the form and content of the auditor's report is affected when the auditor expresses a modified opinion.

There are three types of modified opinions, namely-

1. A qualified opinion
2. An adverse opinion
3. A disclaimer of opinion

1. **Qualified Opinion:** The auditor shall express a qualified opinion when:
   a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or
   b) The auditor is unable to obtain sufficient appropriate audit evidence to express an unqualified opinion, but concludes that the possible effects of the undetected misstatements in the financial statements, if any, could be material but not pervasive.
2. **Adverse Opinion:** An auditor shall express an adverse opinion in a situation where he have obtained sufficient audit evidence and concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
3. **Disclaimer of Opinion:** The auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence to form a basis for his opinion, and he concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.



14.9 FEATURES OF GOOD AUDIT REPORT

Preparing an audit report to express an opinion on the truth and fairness of the financial statements of a company is one of the important functions of an auditor. The report of the auditor serves as basis for decision making for various stakeholders interested in the financial performance of a company. As such, the auditor should take due diligence and utmost care to ensure that the financial statements prepared by the company are as per the framework designed by the provisions of Companies Act, 2013 and they

reflect a true and fair position of the financial statements. Further, the auditor should ensure that report is objective, accurate and simple so that the users of the audit report can count on it.

Following are a few features of a good audit report:

i) Objective: The auditor's report should be very objective and unbiased.

ii) Unambiguous: The auditor's report should not include technical terms and jargon to make the report very simple and straightforward.

iii) Accuracy: The information provided in the report should be very accurate, whether quantified or otherwise.

iv) Conciseness: The auditor's report should be concise but he should also ensure that important information is not omitted.

v) Sufficient appropriate evidence: The auditor's opinion should be based on sufficient appropriate audit evidence to ensure the authenticity and reliability to a desirable extent.

vi) Obtaining reasonable assurance: The auditor should obtain reasonable assurance about whether the financial statements are free from material misstatement, wherever necessary, before expressing his opinion on the financial statements.

CHECK YOUR PROGRESS

Q 4: State the types of modified opinion in an auditor's report.

.....

Q 5: State two features of a good audit report.

.....



14.10 LET US SUM UP

In this unit we have discussed the following-

- Every Company shall apoint an Auditor every year to express his views and opinions on the truth and fairness of the financial statements prepared by the management.

- Auditor's Report on financial statements is not an evaluation or assessment of the figures or items disclosed in the financial statements.
- The main users of the audit report are shareholders, members and all other stakeholders of the Company.
- The Standard on Auditing (SA) 700, "Forming An Opinion And Reporting On Financial Statements" deals with the form and content of the auditor's report on the truth and fairness of financial statements.
- SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report" deals with the auditor's responsibility to communicate key audit matters in the auditor's report.
- SA 705, "Modifications to the Opinion in the Independent Auditor's Report" and SA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report.
- Basic elements of an audit report:
  1) Title
  2) Addressee
  3) Responsibilities for the Financial Statements
  4) Auditor's Responsibility
  5) Auditor's Opinion
  6) Signature of the Auditor
  7) Auditor's Address
  8) Date of the Auditor's Report
- There are three types of modified opinions, namely-
  1. A qualified opinion
  2. An adverse opinion
  3. A disclaimer of opinion
- Features of a good audit report are:
  i) Objective
  ii) Unambiguous
  iii) Accuracy.

iv) Conciseness

v) Sufficient appropriate evidence

vi) Obtaining reasonable assurance



14.11 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.

3) Saxena R. G. (2001). Principles and practice of Auditing, New Delhi, Himalaya Publishing House.

4) ICAI (2016). Advanced Auditing and Professional Ethics, Study Malerial, ICAI, New Delhi.

14.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Every company shall appoint an Auditor every year to express his views and opinions on the truth and fairness of the financial statements prepared by the management. The report prepared by the auditor is called Auditor's Report.

Ans to Q No 2: The responsibility of preparation of financial statements is upon the management of the company.

Ans to Q No 3: Two basic elements of an Audit are:

Title: The auditor's report shall have a title clearly mentioning that it is the report of an independent auditor.

Addressee: The auditor's report should be addressed properly to those for whom the report has been prepared. Generally, audit report is addressed to the members of the company whose financial statements are being audited.

Ans to Q No 4: There are three types of modified opinions, namely-

1. A qualified opinion
2. An adverse opinion
3. A disclaimer of opinion

Ans to Q No 5: Following are two features of a good audit report:

i) Objective: The auditor's report should be very objective and unbiased.

ii) Unambiguous: The auditor's report should not include technical terms and jargon to make the report very simple and straightforward.



14.13 MODEL QUESTIONS

Q 1: Discuss the various provisions of Companies Act, 2013 regarding the Auditor's Report.

Q 2: Discuss the features of a good audit report.

Q 3: Discuss the basic elements of an audit report.

Q 4: Discuss the various types of audit opinions.

*** ***** ***

UNIT 15 : RECENT TRENDS IN AUDITING

UNIT STRUCTURE

15.1 Learning Objectives

15.2 Introduction

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15.7 Let Us Sum Up

15.8 Further Readings

15.9 Answers to Check Your Progress

15.10 Model Questions

15.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- discuss the recent trends in Auditing
- discuss some non-financial subject areas included in Audit
- discuss the use of computer aided tools and techniques in Audit
- know the Standards on Auditing applicable in India.

15.2 INTRODUCTION

The rapid change in computer technology has made the auditing task so dynamic that the auditors are in a need to constantly update their knowledge in computers and follow the Auditing Standards, Statements and Guidance Notes to keep them up to date. The SAs, formerly known as Auditing and Assurance Standards (AAS), are developed in congruence with the international Auditing Standards but conforming to national laws, customs, usages and business environment. The standards on auditing are periodically reviewed and even revised to ensure that the professional accountants in India could discharge their duties with due professional care, competence and sincerity. The auditors need to follow these standards constantly while performing the audit function. Further, rapid growth of business organisations, MNCs, mergers, acquisitions etc. have resulted into auditing task being more complicated. Although auditing was mainly associated with systematic examination of books of accounts of an enterprise so as to find whether such statements represent a true and fair view, but recent auditing has started including non-financial subject areas such as Environmental Auditing, Energy Audit, Forensic Audit, Compliance, Performance Audit etc.

15.3 AUDIT IN AN AUTOMATED ENVIRONMENT

The rapid change in information technology and the growth of business enterprises have made them rely on software systems and applications more than ever. An automated environment refers to a business environment where the processes, operations, accounting and even decisions are taken using computer technology. Every business organisation relies on computer technology for preparing their financial statements. The auditors also often rely on data and reports that are generated from these systems. As a result, there is a sea change between auditing task conducted manually and auditing in an automated environment. However, fundamental nature of auditing does not change even in an automated environment.

15.4 AUDIT OF NON-FINANCIAL SUBJECT AREAS

The auditing task today is no more confined to examination of financial information of an enterprise and make an opinion on the truth and fairness of such information in the financial statements. Instead, various non-financial subject areas have begun to be included under audit. A few of such areas are discussed below:

15.4.1 Environmental Audit

The ICAI has defined Environmental Audit as "A management tool comprising a systematic, documented, periodic and objective evaluation of how well environmental organisation, management and equipment are performing with the aim of helping to safeguard the environment by:

(i) Facilitating management control of environmental process.

(ii) Assessing compliance with company policies, which would include meeting regulatory requirements".

The objectives of the Environmental Audit are:

To evaluate the efficacy of the utilisation of resources of man, machines and materials, and to identify the areas of environmental risks and liabilities and weakness(es) of management system and problems in compliance of the directives of the regulatory agencies and control the generation of pollutants and/or waste.

15.4.2 Energy Audit

As per the Energy Conservation Act, 2001, Energy Audit is defined as "the verification, monitoring and analysis of use of energy including submission of technical report containing recommendations for improving energy efficiency with cost benefit analysis and an action plan to reduce energy consumption".

15.4.3 Performance Audit

Performance audit is an independent, objective and reliable examination of whether government undertakings, programs, systems, activities or organisations are performing in accordance with the principles of economy, efficiency & effectiveness and whether there is room for improvement. Performance auditing seeks to provide new information, analysis or insights and, where appropriate, recommendations for improvement.

According to Regulation 68 of Regulations on Audit and Accounts, 2007 "Performance audit is an independent assessment or examination of the extent to which an organisation, programme or scheme operates economically, efficiently and effectively."

15.4.4 Compliance Audit

Compliance audit is an assessment as to whether the provisions of the applicable laws, rules and regulations made there under and various orders and instructions issued by the competent authority are being complied with. This audit by its very nature promotes accountability, good governance and transparency as it is concerned with reporting deviations, identifying weaknesses and assessing propriety. CAG's Regulations on Audit and Accounts, 2007 recognised compliance audit as distinct stream of audit and these guidelines lay down the principles, approach and processes for regulating compliance audits. Compliance auditing may be concerned with

1) Regularity - adherence of the subject matter to the formal criteria emanating from relevant laws, regulations and agreements applicable to the entity
2) Propriety - observance of the general principles governing sound financial management and the ethical conduct of public officials

While regularity is the main focus of compliance auditing, propriety is equally pertinent in the public-sector context, in which there are certain expectations concerning financial management and the conduct of officials.

15.4.5 Social Audit

The concept of Social Audit originated in the European and American countries in the middle of the 20th centuries as a process of monitoring, appraising and measuring the social performance of the Business organisations. In the 1970s, Abt Associates (the American consultancy firm) conducted a series of social audits which were incorporated into its annual reports. The term Social was proposed by Howard R. Bowen in 1953, in his article on "Social Responsibilities of a Businessman".

Social auditing is the process of assessing and reporting a business's performance on fulfilling the economic, legal, ethical, and philanthropic social responsibilities expected of it by its stakeholders. Social Audit as a process of evaluation and reporting is similar in some respects to a financial audit but it focuses on social performance rather than financial performance. Meghalaya is the first state in India to operationalise a law that makes social audit of government programmes and schemes a part of government practice. The legislation 'The Meghalaya Community Participation and Public Services Social Audit Act, 2017' is applicable to 11 departments and 21 schemes.

15.4.6 Forensic Audit

Forensic Audit is the application of accounting methods to the tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud. A forensic audit requires the expertise of not only accounting

and auditing procedures but also expert knowledge regarding the legal framework. Because of the increasing cases of frauds and misrepresentations in financial and non-financial matters of business enterprises all over the world, forensic audit is emerging as a new area of auditing.



CHECK YOUR PROGRESS

Q 1: State any four non-financial subject areas which have come under the purview of Audit.

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Q 2: Define Performance Audit

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15.5 COMPUTER AIDED AUDIT TECHNIQUES AND TOOLS

While carrying out an audit, an auditor uses various techniques and tools to derive valid and relevant audit evidences and audit samples. Audit techniques means methods or processes by means of which an auditor collects necessary evidence to support his opinion in respect of the propositions and assertions submitted to him for his examination. An auditor uses techniques like audit sampling, verification, vouching, physical examination, confirmations, observations etc. But with the advent of computer systems and its ever changing technologies, there has been a notable change in the auditing techniques and tools. The use of computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures has become prominent. Even then, the overall objectives and scope of an audit do not change when an audit is conducted in a computerised environment.

15.5.1 Advantages of using Computer in Auditing

Audit functions which were performed manually earlier are now performed using standard financial accounting software, suitably modified for a particular system. An audit conducted using computer aided audit techniques and tools helps generate customized reports and maintain a standard audit trail. Further, it saves time with no loss of quality or accuracy.

15.5.2 Effects of Computer in Auditing

Even though audit conducted using computer aided tools and techniques have caused substantial changes in the auditing process, the fundamental nature of auditing has not changed. No doubt the application of computers in the auditing process has improved the efficiency, accuracy and timeliness of the audit work, but it also affected the tools and techniques of auditors used in collection and evaluation of evidence. The various aspects in which computerised environment have affected the auditing process are as follows:

1) Collection of Audit Evidence
2) Evaluation of Audit Evidence
3) Internal Controls
4) Audit Sampling
5) Report Generation

15.5.3 Relying on computer aided audit Techniques

Use of computer aided audit techniques requires auditors to evaluate the reliability of the accounting and internal control systems before executing audit test. The auditor needs to verify that:

1) the data which is made available for processing is authorised, correct and complete.
2) the internal control systems provide for timely detection and correction of errors.

3) the output/reports generated are accurate and complete.
4) adequate measures for data security against fraud, misrepresentation, wrong processing, other natural calamities etc. have been provided.
5) unauthorised changes to the programmes and systems is prevented.



CHECK YOUR PROGRESS

Q 3: State any two advantages of using computer in Auditing.

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15.6 STANDARDS ON AUDITING

The momentous impact of technology in both the operating and financial systems of companies has significantly affected the audit environment. Considering the developments in the field of auditing at international level, issuing Auditing Standards in congruence with international standards but conforming to national laws, customs, usages and business environments was the need of the hour. In this regard, the ICAI as a professional accounting body has been playing a major role to ensure that the professional accountants in India could discharge their duties with due professional care, competence and sincerity. In July 2002, the ICAI converted the Auditing Practices Committee into an Auditing and Assurance Standards Board (AASB) to review the existing auditing practices in India and to develop statements on Standards on Auditing (SAs). Auditing standards represent a codification of the best practices of the profession, which are in existence. Auditing standards also promote uniformity in practice as also comparability. These SAs provide guidance to auditors while performing an audit and issuing a report thereafter. The SAs apply whenever an independent audit of financial information of any entity is carried out.

15.6.1 Procedure for issuing SAs in India

The following procedure is adopted for the formulation of SAs:

- The AASB determines the broad areas in which the SAs need to be formulated and the priority in regard to the selection thereof.
- In preparation of the SAs, the AASB is assisted by the Study Groups constituted to consider specific subjects.
- On the basis of the work of the Study Groups, an exposure draft of the proposed SA is prepared by the committee and issued for comments by members of the Institute.
- After taking into consideration the comments received, the draft of the proposed SA is finalised by the AASB and submitted to the Council of the ICAI.
- The Council of the ICAI considers the final draft of the proposed SA, and, if necessary, modifies the same in consultation with the AASB. The SA is then issued under the authority of the Council.

While formulating the SAs, the AASB takes into consideration the "International Standards on Auditing" issued by the International Auditing Practices Committee (IAPC), applicable laws, customs, usages and business environment in India. The SAs are issued under the authority of the Council of the ICAI. The AASB also issues Guidance Notes on the issues arising from the SAs wherever necessary. The AASB has also been entrusted with the responsibility to review the SAs at periodical intervals.

15.6.2 Compliance with the SAs

While performing the audit function, it is the duty of the auditors to ensure that the SAs are followed in the process. If the auditor is unable to do so for any reason, his reports should disclose the material departures there from.

15.6.3 List of Standards on Auditing

The Council of the ICAI has issued following Standards on Auditing.

Sl. No	No. of Standard	Title of the Standard	Effective Date
General Principles and Responsibilities (SA-200 to SA-299)			
1	SA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing	1-4-2010
2	SA 210	Agreeing the Terms of Audit Engagements	1-4-2010
3	SA 220	Quality Control for an Audit of Financial Statements	1-4-2010
4	SA 230	Audit Documentation	1-4-2009
5	SA 240	The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements	1-4-2009
6	SA 250	Consideration of Laws and Regulations in an Audit of Financial Statements	1-4-2009
7	SA 260	Communication with Those Charged with Governance	1-4-2009
8	SA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	1-4-2010
9	SA 299	Responsibility of Joint Auditors	1-4-1996
Risk Assessment and Response to Assessed Risks (SA-300 to SA-499)			
10	SA 300	Planning an Audit of Financial Statements	1-4-2008
11	SA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	1-4-2008
12	SA 320	Materiality in Planning and Performing an Audit	1-4-2010
13	SA 330	The Auditor's Responses to Assessed Risks	1-4-2008
14	SA 402	Audit Considerations Relating to an Entity Using a Service Organisation	1-4-2010
15	SA 450	Evaluation of Misstatements Identified during the Audits	1-4-2010
Audit Evidence (SA-500 to SA-599)			
16	SA 500	Audit Evidence	1-4-2009
17	SA 501	Audit Evidence - Specific Considerations for Selected Items	1-4-2010

18	SA 505	External Confirmations	1-4-2010
19	SA 510	Initial Audit Engagements - Opening Balances	1-4-2010
20	SA 520	Analytical Procedures	1-4-2010
21	SA 530	Audit Sampling	1-4-2009
22	SA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	1-4-2009
23	SA 550	Related Parties	1-4-2010
24	SA 560	Subsequent Events	1-4-2009
25	SA 570	Going Concern	1-4-2009
26	SA 580	Written Representations	1-4-2009
Using work of others (SA-600 to SA-699)			
27	SA 600	Using the Work of Another Auditor	1-4-2002
28	SA 610	Using the Work of Internal Auditors	1-4-2010
29	SA 620	Using the Work of an Auditor's Expert	1-4-2010
Audit Conclusions and Reporting (SA-700 to SA-799)			
30	SA 700	Forming an Opinion and Reporting on Financial Statements	1-4-2011
31	SA 705	Modifications to the Opinion in the Independent Auditor's Report	1-4-2011
32	SA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	1-4-2011
33	SA 710	Comparative Information - Corresponding Figures and Comparative Financial Statements	1-4-2011
34	SA 720	The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	1-4-2010
Specialised Areas (SA-800 to SA-810)			
35	SA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Framework	1-4-2011
36	SA 805	Special Considerations-Audit of Single Purpose Financial Statements and Specific Elements, Accounts or Items of a Financial Statement	1-4-2011
37	SA 810	Engagements to Report on Summary Financial Statements	1-4-2011



CHECK YOUR PROGRESS

Q 4: Who issues Standards on Auditing in India?

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15.7 LET US SUM UP

In this unit we have discussed the following-

- The rapid change in computer technology has made the auditing task very dynamic.
- The SAs, formerly known as Auditing and Assurance Standards (AAS), are developed in congruence with the international Auditing Standards but conforming to national laws, customs, usages and business environment.
- Recently, auditing has started including non-financial subject areas such as Environmental Auditing, Energy Audit, Forensic Audit, Compliance, Performance Audit etc.
- An automated environment refers to a business environment where the processes, operations, accounting and even decisions are taken using computer technology.
- There is a sea change between auditing task conducted manually and auditing in an automated environment.
- With the advent of computer systems and its ever changing technologies, there has been a notable change in the auditing techniques and tools.
- The use of computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures has become prominent.
- Use of computer aided audit techniques requires auditors to evaluate the reliability of the accounting and internal control systems before executing audit test.

- In July 2002, the ICAI converted the Auditing Practices Committee into an Auditing and Assurance Standards Board (AASB) to review the existing auditing practices in India and to develop statements on Standards on Auditing (SAs)
- While performing the audit function, it is the duty of the auditors to ensure that the SAs are followed in the process.
- If the auditor is unable to do so for any reason, his reports should disclose the material departures there from.



15.8 FURTHER READINGS

1) Basu, S.K. (2008), Auditing: Principles and techniques, New Delhi, Pearson Education Ltd.

2) Gupta K. (2005), Contemporary Auditing. New Delhi, Tata McGraw Hills.

3 Saxena R. G. (2001). Principles and practice of Auditing, New Delhi, Himalaya Publishing House.



15.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: a) Environment, b) Energy, c) Performance, d) Compliance

Ans to Q No 2: According to Regulation 68 of Regulations on Audit and Accounts, 2007

"Performance audit is an independent assessment or examination of the extent to which an organisation, programme or scheme operates economically, efficiently and effectively."

Ans to Q No 3: (i) helps generate customized reports and maintain a standard audit trail.

(ii) it saves time with no loss of quality or accuracy.

Ans to Q No 4: The Council of the Institute of Chartered Accountants in India (ICAI) issues Standards on Auditing in India.

15.10 MODEL QUESTIONS

Q 1: Discuss the various non-financial subject areas which have come under the purview of Audit.

Q 2: Write a note on: Audit in an Automated Environment.

Q 3: What is meant by Computer aided techniques and tools? State the advantages and disadvantages of using Computer in Auditing.



Q 4: What is meant by Standards on Auditing? State the procedure for issuing Standards on Auditing in India.

Q 5: List down the various Standards on Auditing issued by the Council of the ICAI.

*** ***** ***



REFERENCE

1) Fundamentals of Auditing by S. K. Basu, Publisher-Pearson
2) Auditing : Principles and Techniques by S. K. Basu, Publisher-Pearson
3) Auditing : Principles and Practice by R. Kumar and V. Sharma, Publisher-PHI Learning
4) A Hand book of Practical Auditing by B. N. Tandon, S. Sudharsanam and A. Sundharabahu, Publisher-S. Chand Publishing
5) Contemporary Auditing by Gupta K., New Delhi, Publisher-Tata McGraw Hills.
6) Principles and Practice of Auditing by Saxena R. G., New Delhi, Publisher-Himalaya Publishing House.
7) Advanced Auditing and Professional Ethics, ICAI, New Delhi.

কাকতৰ নাম ঃ
পাঠ্যবিষয়ৰ কোড (সাংকেতিক সংখ্যা) ঃ

আভ্যন্তৰীণ গুণগত আশ্বাসন কেন্দ্ৰ (CIQA)
কৃষ্ণকান্ত সন্দিকৈ ৰাজ্যিক মুক্ত বিশ্ববিদ্যালয়
নগৰ কাৰ্যালয়, হাউছফেড কমপ্লেক্স, গুৱাহাটী-০৬

পাঠ্যবিষয় সন্দর্ভত শিক্ষার্থীৰ সঁহাৰি

প্ৰিয় শিক্ষার্থী,

ওপৰত উল্লেখ কৰা পাঠ্যবিষয়টোৰ সন্দর্ভত আপোনাৰ বহুমূলীয়া মতামত আৰু মন্তব্য বিচৰা হৈছে। আপোনাৰ সঁহাৰিয়ে আমাক ভৱিষ্যৎ স্ব-শিক্ষণ সামগ্ৰীবোৰৰ মান উন্নত কৰাত সহায় কৰিব। অনুগ্ৰহ কৰি তলৰ প্ৰবিৱৰণবোৰৰ বিপৰীতে আপোনাৰ মতামত উপযুক্তভাৱে প্ৰতিফলিত কৰা বিকল্পটোত চিন দিয়ক। মন্তব্যৰ সৈতে সম্পূৰ্ণ সঁহাৰি জনোৱাৰ পাছত পৃষ্ঠাটো ফালি তলৰ ঠিকনাত ডাকযোগে প্ৰেৰণ কৰে যেন।

সঞ্চালক,

আভ্যন্তৰীণ গুণগত আশ্বাসন কেন্দ্ৰ, কৃষ্ণকান্ত সন্দিকৈ ৰাজ্যিক মুক্ত বিশ্ববিদ্যালয়
হাউছফেডকমপ্লেক্স, দিছপুৰ, গুৱাহাটী-০৬
ই-মেইল ঠিকনা ঃ ciqa@kkhsou.in

১) পাঠ্যবিষয়ৰ অন্তৰ্ভুক্ত অধ্যায়বোৰ পঢ়িবলৈ আপুনি আনুমানিকভাৱে কিমান ঘণ্টা ব্যয় কৰিলে ? [ ][ ][ ]

২) খণ্ডটো অধ্যয়ন কৰাৰ অন্তত তলৰ প্ৰবিৱৰণবোৰ সন্দর্ভত আপোনাৰ মতামত ব্যাখ্যা কৰক (✓ চিন দিয়ক)

ক্ৰমাংক	প্ৰবিৱৰণ					
i)	পাঠ্যবিষয়ৰ স্ব- শিক্ষণ সামগ্ৰীবোৰে প্ৰতিটো অধ্যায়ৰ আৰম্ভণিতে ধাৰ্য কৰি লোৱা শিক্ষণ উদ্দেশ্যবোৰ পূৰণ কৰিব পাৰিছে	দৃঢ়ভাৱে একমত	একমত	একমতো নহয় অসন্মতো নহয়	অসন্মত	দৃঢ়ভাৱে অসন্মত
ii)	স্ব- শিক্ষণ সামগ্ৰীত সন্নিৱিষ্ট অধ্যায়বোৰে মোৰ শৈক্ষিক প্ৰয়োজনীয়তা আৰু প্ৰত্যাশা পূৰণ কৰিব পাৰিছে					
iii)	অধ্যায় লেখক/লেখিকাসকলৰ পাঠ্যবিষয়ত সন্নিৱিষ্ট পাঠসমূহৰ উত্তম জ্ঞান আছে					
iv)	অধ্যায়বোৰত সন্নিৱিষ্ট পাঠবোৰৰ ভাষা আৰু বিষয়বস্তু মই সহজে বুজি পোৱা ধৰণে উপস্থাপন কৰা হৈছে					
v)	অধ্যায়বোৰত কাৰ্যকলাপত ভাগ ল'ব পৰাকৈ/অনুশীলনীত অংশগ্ৰহণ কৰিব পৰাকৈ পৰ্যাপ্ত সুযোগ আছে					
vi)	ধাৰণাবোৰ স্পষ্ট কৰিবলৈ পৰ্যাপ্ত চিত্ৰ (ৰেখাচিত্ৰ, তালিকা ইত্যাদি) সংলগ্ন কৰা হৈছে					
vii)	পাঠবোৰত সন্নিৱিষ্ট বিষয়বস্তুসমূহ চিত্তাকৰ্ষক, প্ৰাসংগিক আৰু শেহতীয়া তথ্যভিত্তিক					
viii)	'অগ্ৰগতি নিৰীক্ষণ' শিতানৰ প্ৰশ্নবোৰ যথেষ্ট উপযোগী					
ix)	'আৰ্হি প্ৰশ্ন' আৰু 'অগ্ৰগতিৰ খতিয়ান' শিতান দুটাই মোক যথেষ্ট উপকৃত কৰিছে					

অতিৰিক্ত মন্তব্য (অনুগ্ৰহ কৰি মুকলিমূৰীয়াকৈ মতামত আগবঢ়াওক) ঃ

১) আপোনাৰ মতে স্ব-শিক্ষণ সামগ্ৰীবোৰৰ কোনকেইটা দিশ সবাতোকৈ ফলপ্ৰসূ হৈছে?

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২) স্ব-শিক্ষণ সামগ্ৰীবোৰৰ সামগ্ৰিক গুণ উন্নত কৰিবলৈ কৃষ্ণকান্ত সন্দিকৈ ৰাজ্যিক মুক্ত বিশ্ববিদ্যালয়ে কেনেধৰণৰ পৰিৱৰ্তন/উন্নতি সাধন কৰিব পাৰে বুলি আপুনি ভাবে?

প্ৰ-পত্ৰ পূৰাবলৈ সময় উলিওৱাৰ বাবে আপোনাক ধন্যবাদ জনালোঁ।