AUDITING

A STUDY MATERIAL

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3) "An audit is an investigation by an auditor into the evidence from which the final revenue accounts and balance sheet or other statement of an organisation have been prepared, in order to ascertain that they present a true and fair view of the summarised transactions for the period under review and of the financial statement of the organisation at the end date, so enabling the auditor to report thereon".

- Taylor and Perry

4) "An audit is an examination of acounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate".

- Lawwrence R. Dicksee

5) "An audit is examination of such records to establish their reliability and the reliability of statements drawn from them"

- A.W. Hanson

6) "Auditing is a systematic examination of the books and records of a business or other organisation, in order to ascertain or verify to report upon the facts regarding its finacial operation and the result thereof".

- Montgomery

7) "An audit is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon".

- Auditing and Assurance Standard

To sum up, auditing may be defined as a systematic examination of books of accounts of a business with the help of vouchers, documents, information and explanations received from authorities in order to report that the balance sheet reveals a true and fair view of the state of affairs of the concern, the profit and loss account, a true and fair view of profit or loss for the financial period and the accounts have been prepared in confirmity with the law.

Essential Characteristics of Auditing

Auditing exhibits the following characteristics.

1. Audit is an independent, scientific, intelligent and critical examination of the books of account or accounting records of a business.
2. Such an examination enables the auditor to satisfy himself that the financial statements have been properly drawn up, and exhibit a true and fair view of the financial state of affairs of the business for the accounting period.
3. Its important part is detection of errors and frauds.
4. The auditor goes through vouchers and other related documentary evidence in order to report on the financial health of the business.

If an auditor experiences any constraint on the scope of audit, he is to make a statement of the same in his report.

OBJECTIVES OF AUDIT

The objectives of an audit may broadly be divided into

I. Primary Objective
II. Secondary Objectives
III. Specific Objectives

I. Primary Objective

The Companies Act requires an auditor to state whether in his opinion, the accounts are prepared in confirmity with law and disclose the true and fair view of the state of company's affairs or not. This is called *expression of expert opinion.*

a) Whether financial statements are prepared in confirmity with law

Balance sheet portrays the financial position of a concern as on a particular date. Profit and loss account discloses the operating results of the period covered

in the statement. While auditing, greater reliance is to be placed on the accounting system in use. An auditor resorts to test checking to decide on the reliability of accounts. Accounts prepared in confirmity with law are true to the purpose.

b) Whether financial statements present a true and fair view

The primary objective of an independent financial audit is to determine whether the financial statements present a factual and impartial view of the financial position and working results of an enterprise. The balance sheet should reveal the true and fair view of the state of affairs of the business and the profit and loss account a true and fair view of the profit or loss for the financial period.

II. Secondary Objectives

An auditor has to examine the books of account and relevant supporting documents. During the process, certain errors and frauds may be discovered. These can be discussed under two heads detection and prevention of errors and mistakes and (b) detection and prevention of frauds.

Detection and Prevention of Errors and Mistakes

Error in accounting refers to an unintentional misstatement of financial statements. Errors and mistakes are of various kinds.

1) Clerical Errors

Clerical errors arise because of mistakes committed by the clerical staff in ordinary course of accounting work. These are of five types.

(i) Errors of omission

Errors of omission occur on account of transactions not being recorded in the books of account either wholly or partially. It is difficult to detect such errors, as they do not affect the arrangement of trial balance. A critical scrutiny of accounts only can uncover such errors. Omission can be either *whole* or *partial.* When a transaction is totally omitted from the books, it is "complete omission". For example, omission of entering purchases or sales entirely. When a transaction is partially recorded it is known as *"partial omission"*. For example, salaries for only 11 months have been accounted for and the outstanding amount of 12th month has not been provided for.

(ii) Errors of commission

These contain incorrect additions, wrong postings and entries. Examples of this kind include the following.

- errors in addition, carry forwards in the books of original entries or ledger.
- errors or incorrect postings such as debit amount posted to credit, wrong amounts posted to an account, an amount posted twice, omission to post an amount from a book of original entry to the ledger
- errors in taking out balances of the ledger accounts.

The above errors do affect the agreement of the trial balance. Checking the arithmetical accuracy of books of original entries and ledger and postings from the books of original entries to the ledgers may detect such kind of errors.

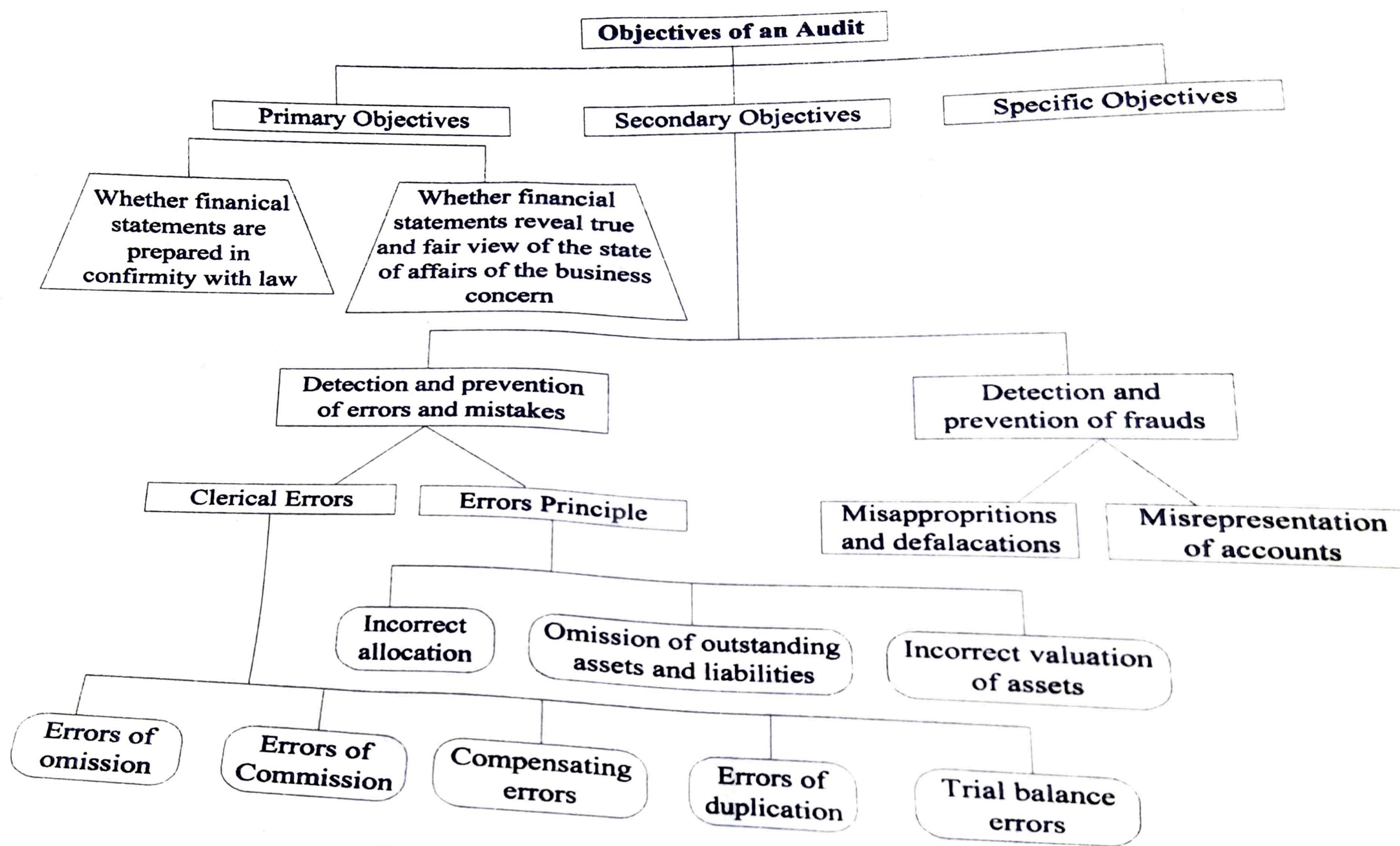

Figure 1.1 – Objectives of an audit

(iii) Compensating errors

An error is compensated or counter balanced by another error. The adverse effect of one on debit side or credit side is neutralised by that of another on credit or debit side.

Compensating errors counter-balance each other. Despite errors, two sides of the trial balance tally.

For example, a cash sale of Rs. 10,000 may be recorded in the cash book as Rs. 1,000, another cash sale of Rs. 1,000 may be recorded as Rs. 10,000.

(iv) Errors of duplication

An entry in a book of original record is made twice and posted twice as well. They cannot be located easily as the agreement of the trial balance is not affected. For instance, invoice sent in duplicate entered twice in the books and posted twice in the ledger. Only thorough checking will help detect duplication.

(v) Trial balance errors

Trial balance errors consist of casting errors in the trial balance, omission of a balance while extracting balance from the books of account, or entering an amount incorrectly or on the wrong side. These errors can be located during routine checking.

2) Errors of Principle

Misapplication or overlooking accounting principles causes errors of principle. There are three types of errors generally regarded as errors of principle.

i) Incorrect allocation

Errors arise when the distinction between revenue and capital is not strictly observed. For example, capital expenditures charged to revenue and *vice versa.*

ii) Omission of outstanding assets and liabilities

Prepayments are ignored and the amount charged from the profit and loss account and outstanding expenese (in respect of rent, salaries, commission etc.) are ignored and not accounted for.

iii) Incorrect valuation of assets

Fixed assects for example are not valued at cost less depreciation, closing stock is not valued at cost or market price, whichever is less.

The following kinds of errors also fall in this category.

- excess or inadequate provision for depreciation
- excess or wrong provision for bad and doubtful debts
- overvaluation or undervaluation of closing stock etc.

Errors can be detected by an intelligent vouching and a complete verification of the assets and liabilities.

Location of Errors

1) An auditor should check the trial balance in the following ways.

(i) Check casts total of the trial balance, list of debtors and creditors.

(ii) Establish the amount of difference.

(iii) Check balances from personal and impersonal ledger into the tria balance.

(iv) Ensure that the closing balances are correctly entered in the right column

2) Short-cut method may also be followed.

(i) For the amount entered on the wrong side, look for an item of half tha amount.

(ii) The difference divisible by nine may mean an error of transposition of figures. For example, 78 written as 87.

(iii) The difference in round figure may be due to mistakes made in totals of trial balance or carry forward of its figures.

(iv) For difference of large amount, compare the trial balance with the previous year's.

(v) For difference of amount which constantly recurs in the books, check all the postings of this amount.

3) Extensive checking may be resorted to, if shortcuts do not yield results.

(i) Ensure that all opening balances have been correctly brought forward in the current year's books.

(ii) Check casts, cross casts and carry forwards of the various books of original entries and ledgers.

(iii) If the ledgers were self-balancing, check the balances, postings, and casts of only that ledger the trial balance of which does not agree.

Detection and Prevention of Frauds

Frauds are internal irregularities aimed at cheating or causing loss to another. One or more individuals acting in collusion with one another commit frauds. It is their intentional misrepresentation of financial information for unauthorised gains.

Characteristics of Frauds

The Institute of internal auditors give the characteristics of frauds.

(i) Frauds are an array of irregularities and illegal acts characterised by intentional deceiving. Persons indulging in frauds gain at the expense of the organisation.

(ii) Frauds are committed for the benefit of the organisation. People inside the organisation deceive outside parties. For example, tax frauds, intentional concealment of material information to impress outsiders about financial position of the company, improper valuation of assets and liabilities, illegal contribution to political parties, etc.

(iii) Frauds are committed to give benefit to an employee, an outsider or another firm at the cost of the organisation. Examples include taking bribes, misusing inside information, embezzlement of cash, defalcation, misappropriation, etc.

Forms of Fraud

A fraud may be in the form of misappropriations and defalcations and misrepresentation of accounts.

1) Misappropriations and defalcations

Cash and goods are misappropriated by showing fictitious entries in records.

(i) Embezzlement of cash

Embezzlement of cash refers to falsification or misappropriation of cash. It is very common in big business concerns as the proprietor has very little control over the receipts, and payments of cash. Cash may be misappropriated in a number of ways as follows.

- Omitting to enter the cash receipts
- Entering less than what is received
- Omitting to record sales and taking away the sale proceed
- Teeming and lading — concealing the money received from the first customer and entering in his account when cash is received from second one and so on.
- Making fictitious entries for discounts, returns, bad debts etc.
- Wages are entered for dummy workers
- Recording fictitious purchases and misappropriating the cash involved.
- Suppressing credit notes received from creditors for purchase returns and discounts.

In order to defect misappropriation of cash, the auditor should check the cash book with original records, counterfoils of receipt book, bills register, salesmen's reports, invoices, wage sheets, salary book, vouchers, etc. Strict control should be exercised over the receipts and payments of cash. The work of one clerk can be automatically checked by another clerk. Such system is known as internal check system.

(ii) Misappropriation of goods

An employee may take away the goods of the company for his personal use. It is very common especially when goods are not bulky and are of less value. Detection can be possible only if proper records of stock inward and outward are maintained. Accurate stock recording through proper accounting for purchases and sales is essential. Periodical checking of stock can minimise the possibility of such misappropriation.

2. Misrepresentation of accounts

This is fraudulent manipulation or falsification of accounts. To reveal the distorted picture, the accounts of a firm may be falsified. By making false entries, the accounts of a firm are manipulated to reveal the distorted picture. Usually, a very large amount is involved in this type of fraud. It is committed by those responsible persons who are in top management, *viz,* directors, managers, etc. Devices adopted for this purpose may be as follows:

- Undervaluation and overvaluation of closing stock and other assets.
- Overvaluation and undervaluation of liabilities
- Creating excess or less provision for depreciation, or not at all providing for depreciation.
- Charging capital expenditure to revenue and *vice versa*
- Providing for excess or less dousbtful debts
- Writing off excess or less bad debts

The objects behind manipulation are dual.

1) To show more profits than the actual ones. It is to earn more commission on profits when payable on the basis of performance and to win the confidence of shareholders by claiming that the firm is able to generate high profit. It is *window dressing.*
2) To show less profits than the actual ones. This may be to mislead income tax authorities and to buy back shares in the open market at lower price besides cheating shareholders by declaring less dividend and to conceal the true position of state of affairs of the business. It is referred to as creating secret *reserves.*

A brief description of window dressing and secret reserves follows.

(i) *Window dressing*

In window dressing, accounts are prepared in such a manner to reveal a much better and sound financial position of the business enterprise. The objectives of window dressing are

- To attract potential investors to subscribe for the shares
- To avail further credit
- To enhance the reputation in the market by showing more sound financial position than the real.
- To win the confidence of stakeholders
- To increase the price of shares artificially.

Qualifications and Qualities of an Auditor

An auditor must be professionally qualified. He must be a chartered accountant within the meaning of the Chartered Accountants Act, 1949. In addition, he should possess the certificate of practice. Apart from the statutory qualifications, some traits and qualities are required for him.

1. Knowledge of Accounting

The auditor must have a thorough knowledge of principles, theory and practice of accountancy. It would be difficult to critically examine the accounts furnished by others unless he is well versed in preparation of accounts. Accounting rules are the criteria for ensuring that the accounting information is properly recorded. He should also be aware of the latest developments in the field of accounting. In concise, an auditor should be a skilful accountant.

2. Knowledge of Practical Auditing and Laws

A thorough knowledge of theory and practice of auditing is required for an auditor. Besides, he should be familiar with various legislations of the country governing a business such as tax laws, corporate laws, economic laws, Sale of Goods Act, Foreign Exchange Management Act, etc. He should have mastery in his field.

3. Intelligence and Tactfulness

To understand the state of affairs of client's business, he must make an intelligent and exhaustive inquiries. Th auditor should be tactful in dealing with clients, staff.

4. Responsibility and Prudence

The auditor should be responsible in terms of his attitude as well as approach to work. When his suggestions are sought on matters relating to financial policy or for improvements in the financial system and internal controls prevailing in the organisation, he should be prudent enough.

5. Awareness about Amendments affecting Audit

The auditor should be fully aware of new changes and developments in the field of auditing. The business has to respond to changes in environment. Regulatory Framework changes frequently. Knowledge of amendments in law is required for the auditor.

6. Honesty and Integrity

The auditor must always be honest. He must not certify what he does not believe to be true. He must possess high moral standards. An auditor should exercise utmost integrity and maintain a separate account for the amount entrusted to him.

7. Objectivity, Independence and Transparency

Objectivity is the essence of audit qualities. The auditor is to conduct audit with open mind and should refrain from having any biased ideas or preconceived notions. Expression of independent opinion on the financial statements by an auditor is the most basic objective of audit. So he must be under the influence of the client. He must show transparency in his approach.

8. Diligence and Vigilance

The auditor's job is analytical in nature. So, he may be critical but not negative. His audit work should be diligent so as to be a model and reference point for his professional peers.

The auditor should always be cautious. He should be able to detect errors and frauds. If he is not vigilant errors and frauds may go undetected.

9. Loyalty and Confidentiality

The auditor should be loyal to his profession. The auditor should respect confidentiality of the information acquired in the course of his work. He should not disclose any such information to third party without a specific authority. This confidentiality should extend even after he ceases to be the auditor of the organisation.

10. Communication Skill

An auditor should communicate well with all the concerned. He should be able to write report properly. The audit report should convey his message in a clear and concise manner.

11. Impartiality

An auditor should be impartial. He should not take any undue influence in performing his duties as an auditor.

A Critical Appraisal of Auditing

Some people view that accounting is a necessity while auditing is a waste. Incurrence of expenditure on accounting is justified in the following ways.

(i) A businessman cannot keep in his memory a large number of unrecorded transactions for long. So, business transactions need to be recorded properly.

(ii) Only from written records a correct amount of profit can be known.

(iii) Accounting reflects the financial position of the business on a given date.

(iv) Written records help prepare lists of debtors and creditors.

(v) Accounting records help prepare lists of debtors and creditors.

(vi) Measures of productivity or growth are from the accounting sources.

(vii) In case of legal dispute, accounting records serve as a documentary evidence.

(viii) Tax liability is arrived at from written records.

(ix) Written accounting records facilitate comparative study of accounting periods of various firms.

(x) Financial institutions grant loans on the basis of financial position of the borrower as reflected by accounting records.

Arguments against Auditing

Many view that auditing may be a luxury for the following reasons.

(i) Payment of auditor's remuneration and fees unnecessarily burdens the profit and loss account.

(ii) Too many audit formalities create hurdles to the accounting staff.

(iii) A long run audit obstructs the smooth functioning of the business.

(iv) Audit is not a fool proof method of detecting errors and frauds.

(v) Auditors act "hand in glove" with the management being their appointing authority. Instances are quoted to substantiate this.

Aruguments in Favour of Auditing

Auditing cannot be considered a waste of resources. It may be luxury for small businessmen. But large and complex business with many stakeholders need auditing as a bare necessity.

(i) Greater reliability is placed on audited accounts in comparison of unaudited ones.

(ii) Audit exposes errors, frauds and scams.

(iii) Auditor can advise the management on matters detrimental to organisational welfare.

(iv) In the presence of regular audit, the client's staff are careful and vigilant as well.

(v) Audit safeguards various stakeholders of the organisation such as investors, owners, employees, financial institutions, creditors and the management.

(vi) Public funds need to be audited so as to ensure their optimum utilisation.

(vii) Audit is statutory in many respects.

4) agreements of purchase or sales which are prejudicial to the interest of the organisation.

Techniques of Auditing

Certain techniques are employed by the auditor to obtain evidence in relation to auditing. *Standard Auditing Practices* suggest various techniques of auditing to be used under different circumstances.

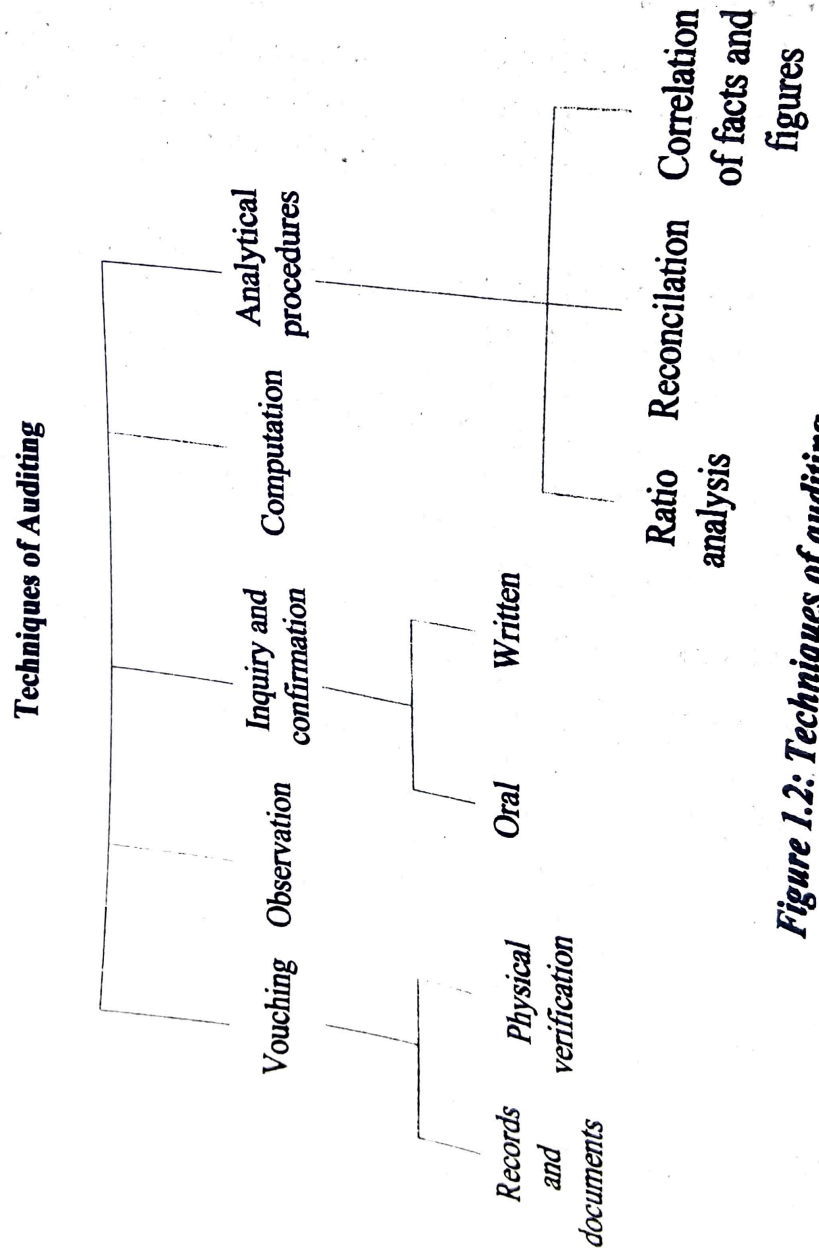

Figure 1.2: Techniques of auditing

1. Vouching (Inspection)

Vouching refers to the inspection of documentary evidence supporting and substantiating a transaction. *A voucher is an evidence of occurrence of a transaction that is entered in the books of accounts.* While verifying various transactions, the auditor examines the supporting documents and records.

(i) Documents and records

An auditor indulges in scanning of records. While going through accounting records and documents, if he comes across any unusual transactions, he verifies them thoroughly. The purposes are to confirm the authenticity of the transaction, find whether the transactions and the supporting documents are appropriate, ensure whether transactions are duly authorised and to ensure whether the classification of the transaction is proper.

Documents held by the third parties are more reliable than the ones in the organisation.

(ii) Physical verification

Documents denote keeping of some items in their physical form. Then they can be verified for quantity and quality as shown in the records. By physical examination, the auditor ensures the availability of item.

2. Observation

By collecting data or evidences, an auditor comes to know the functioning of the systems in the organisation. A close observation enables the auditor to acquire a thorough knowledge of systems and procedures in force. An evaluation of efficiency and effectiveness of them is possible. For example, the internal control measures applicable to cash transactions, receipt or issue of material, stock taking, physical inventory procedures etc., are studied to gain an insight into the working of the systems.

3. Inquiry and Confirmation

Inquiry is seeking information from the persons working in the organisation or from the sources outside the organisation. Confirmation is confirming the information available with the records of the organisation or with the persons outside the organisation. Confirmation may be either oral or written. The auditor has every right to seek clarification on matters which in his opinion is necessary for the conduct of audit. Confirmation through interview or open communication with persons is essential to ensure the authenticity of information. Usually, the balances of debtors shown in the accounting records are confirmed with the debtors of the organisation.

4. Computation

The auditor during the course of audit needs to make appropriate calculation and verify the accuracy of the accounting records. For example, the auditor calculates the interest on borrowing by taking into consideration the amount of

loan, rate of interest and the date of borrowing; the depreciation to be charged for the year by considering the value of depreciable assets, dates of acquisition, rates of depreciation, methods of depreciation adopted, etc.

5. Analytical Procedures

Analytical procedures are required to ensure consistency of accounting methods and also to evaluate the efficiency of management by comparing the results of past years. *Example:* reconciliation ratios, variance analysis. Analytical procedures are also useful in managerial decision making. *Example:* marginal costing, standard costing etc.

Standards of Auditing

Aiming at uniformity of auditing throughout the world, the International Auditing Practices Committee has issued standards on auditing. These standards are acceptable to many countries. In India, the international standards are used in modified forms. Accordingly, standards auditing practices are issued by the Institute of Chartered Accountants of India. In addition, it issues accounting standards, statements, guidance notes and publishes research studies.

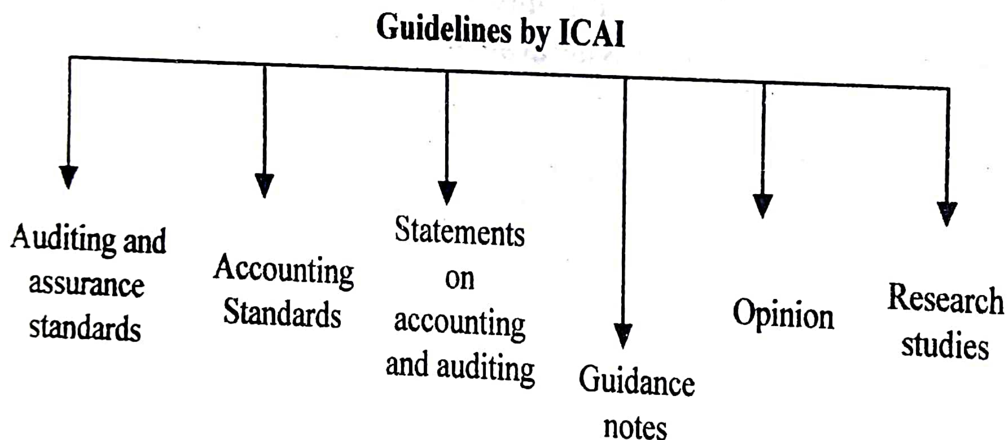

Figure 1.3: Various documents issued by ICAI

1) Auditing and Assurance Standards

ICAI has been issuing a series of "auditing and assurance standards." An auditor is required to mention in his audit report that audit was conducted in accordance with auditing standards generally accoepted in India. Suppose if he deviated from standards for unavoidable reasons, he should state this fact in his report.

2) Accounting Standards

Accounting Standards Board was set up in 1977. ICAI has been issuing accounting standards on important accounting issues. These standards are revised in accordance with the international accounting standards and the conditions and practices prevailing in India.

3) Statements on Accounting Standards

Statements on accounting and auditing matters have been issued by ICAI. Such Statements in force include Statement on Auditing Practices, Statement on Payments to Auditors for other Services, Statement on the Companies (Auditor's Report) Order, 2003 Statement on Qualication in Auditor's Report and Statement on the Amendments to Schedule VI to the Companies Act.

In addition, ICAI has issued statements on peer review and continuing professional education.

4) Guidance Notes

The council of ICAI and its committee issue guidance notes whenever necessary. They provide guidance to members on the matters that may arise in the course of audit work and also on which assistance is sought to resolve them. Basically, guidance notes are recommendatory in nature. Whether the guidance notes have been followed or not should be mentioned in the audit report.

5) Opinions

An advisory committee furnishes opinions on specific queries. Every year ICAI publishes a compilation of opinions given on queries raised by members. Opinions have found only a limited application. They are relevant only to those matters on which opinions were sought.

6) Research Studies

The research studies issued by the Institute are very much useful to auditors. Whenever an auditor faces a difficult situation, he may follow the findings of the research studies.

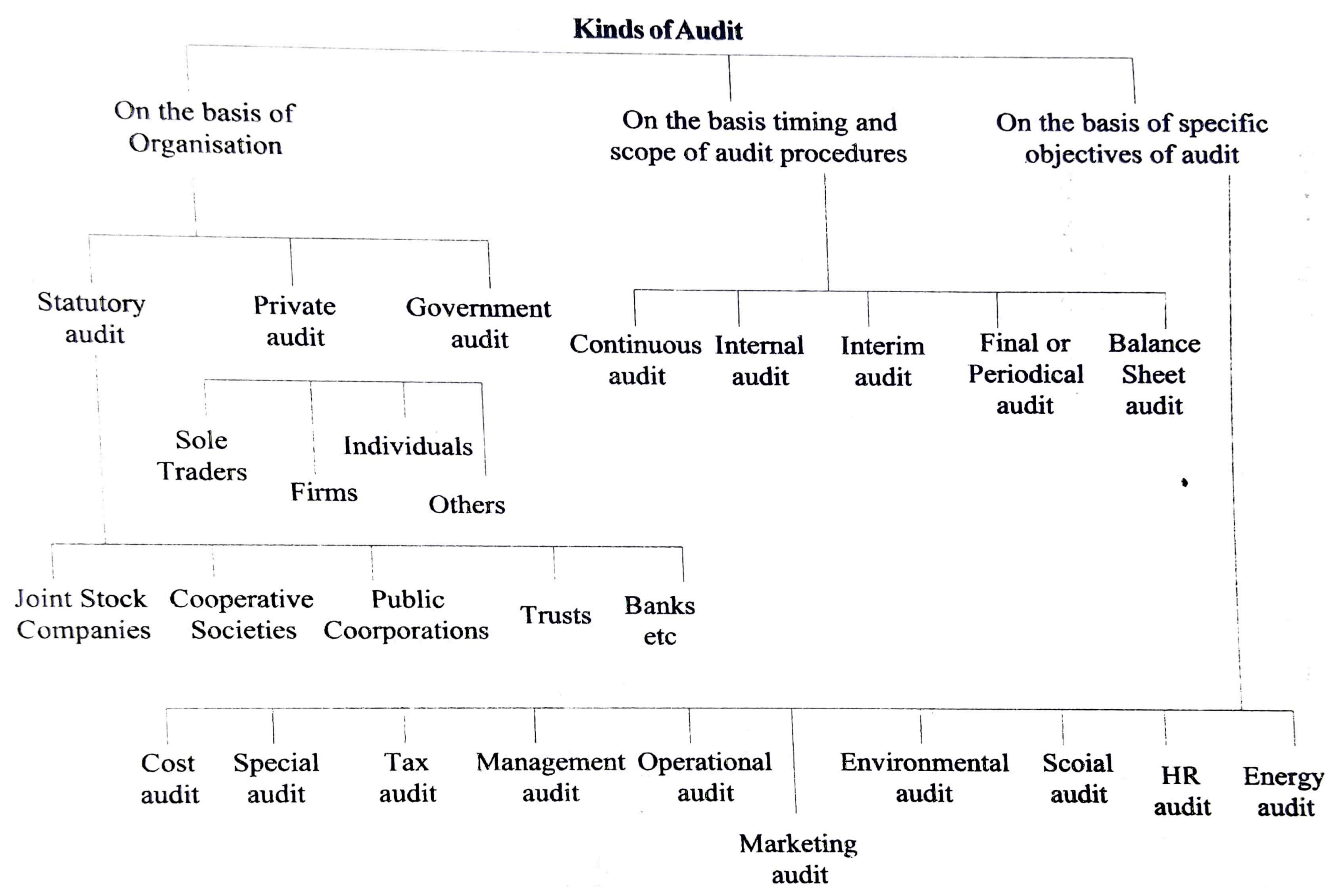

Figure 2.1: Classification of audits

Chapter 2

Classification of Audit

Audits are of several types. Each type of audit involves different procedures. So, it is logical to discuss various kinds of audit before outlining the procedures to be followed. The following are the bases for classifying the audit examination.

I. Organisational Structure

II. Timing and scope of audit examination

III. Specific objectives behind audit

I. On the basis of Organisational Structure

On the basis of organisation structure, audits may be of

1. Statutory audit
2. Private audit and
3. Government audit

1. Statutory Audit

Audit is made compulsory for undertakings formed under the statue or laws. Under the Indian Companies Act, 2013 joint stock companies in India have to get their accounts audited by an independent professional accountant. Shareholders are the real owners of the company. Directors are elected from among shareholders to supervise the overall affairs of a company. Day -to -day working is entrusted to managerial personnel appointed for the purpose. Shareholders want the financial statements to exhibit true and fair view of company's state of affairs. People invest money in the shares on the basis of the financial position and profitability of the company. Moreover, financial institutions, banks, trade creditors, tax authorities, etc., do rely on the financial statements of the company. Considering all these factors, the Companies Act requires companies to undergo audit legally.

Cooperative Societies Registered under the Cooperative Societies Act

Every cooperative society is registered with the Registrar of Cooperative Societies of the State concerned under the Cooperative Societies Act, 1912. A cooperative society is an entity distinct from its members. All the members contribute capital but the management of the society is entrusted to a few members elected for this purpose. So, members are interested in the welfare of their society. To safeguard their interest, the Registrar of Cooperative Societies appoints The sole trader gets several benefits from audited accounts.

auditors to audit the accounts of a society. The auditor submits a report to the Registrar and to the society concerned for the consideration of its members.

Public Corporations

Public Corporations such as Reserve Bank of India, the Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India, LIC, UTI, etc., are some examples of public corporations operating in the country. They are the creation of law. Audit of their accounts by a qualified auditor is a must. Powers, duties and liabilities of the auditors of public corporations are defined by the relevant statutes.

Trusts

Trusts are created under the Indian Trusts Act. They work for charitable and religious purposes. Weak and helpless sections of the public benefit from trusts. Trustees are appointed to take care of the assets and working of the trust. Trust operations are governed by a trust deed. Chances of fraud and misappropriation of trust properties and funds are high. So, there is a provision for audit of trust accounts by a qualified auditor. Audited accounts reflect a true and fair view of working of trusts.

Banks and Others

Banks are established in the form of a joint stock company. But their purposes are unique. Accounts maintained by them are special. Besides, banking institutions, public utility concerns such as electricity boards, insurance companies, local authorities etc., are audited under the category of statutory audit.

2. Private Audit

The private audit is not mandatory under any statute or law. Individuals, sole trading concerns, partnership firms and other private institutions like clubs, libraries, hospitals, schools, colleges and other educational institutions may get their accounts audited in view of several benefits resulting from it.

Audit of Individuals and HUFs.

Individuals who have high volume of transactions and Hindu Undivided Families running family business appoint accountants to prepare and maintain accounts. They may appoint auditors to verify the accuracy of accounts. Scope of audit will depend upon the agreement entered into with the client.

Audit of individuals will help in case of any tax problem, ensure the accuracy of the accounts, keep a moral check on employees, reveal true income from various sources and have a fair valuation of assets.

Audit of Sole Traders

Audit of accounts of soleproprietary is optional. A soleproprietary concern is owned, managed and controlled exclusively by an individual. It is his individual

decision to get his accounts audited. The nature and scope of audit to be undertaken will depend upon the agreement entered into for this purpose.

The sole trader gets several benefits from audited accounts.

1. It assures the trader that his incomes are properly accounted for and his expenditures properly vouched.
2. Fraud and misappropriation indulged in by employees are exposed.
3. It acts as a moral check on employees.
4. Audited accounts are reliable for income tax purposes.
5. Audited accounts facilitate easy comparison of financial matters over years.

Audit of Partnership

The partnership Act, 1932 does not require a partnership firm to audit its accounts.Still firms go in for audits. The auditor is not appointed under any statute but by an agreement between the partners and auditor. The nature and scope of audit, auditors rights, duties, liabilities and audit fee are as per the agreement.

While auditing partnership accounts, the auditor should pay attention to the following:

1. Partnership Act 1932
2. Partnership deed
3. Nature of business
4. Names and address of all partners
5. Capital introduced by partners
6. Borrowing powers of partners
7. Profit sharing ratios
8. Interest on capital
9. Interest on drawings
10. Salary, commission, bonus and remuneration payable to partners

Audit of partnership firms offers the following advantages:

(i) Partners are assured that the books of accounts are maintained properly and financial statements give a true and fair view of state of affairs of the business.

(ii) Audited accounts ensure a fair valuation of goodwill of the firm on the occasions of admission, retirement or death of a partner or for any other reason.

(iii) It ensures easy settlement of amount due to a retiring partner or the legal heir of the deceased partner.

(iv) On the basis of audited accounts, firms can obtain loan from financial institutions.

(v) Frauds and errors can be detected in the initial stage itself.

(vi) There is accuracy and reliability of accounts.

Audit of Accounts of other Entities

For entities like clubs, libraries, hospitals, colleges, schools, etc., audit of accounting data is not obligatory. However, they get their books of account audited so as to present a clear picture of their business. At times, these organisations avail themselves of grants from Government. An utitilisation certificate on the basis of audited accounts has to be submitted.

3. Government Audit

Government offices, departments, undertaking registered as companies are subject to independent financial audit. A statutory auditor appointed by the Central Government on the advice of the Comptroller and Auditor General of India audits accounts of such concerns.

Objectives of the government audit

(i) To ensure that the financial transactions of the concerned organisation are executed with approvals of proper authorities, have been accurately recorded and comply with the rules of financial propriety.

(ii) To ensure that all the expenses have been incurred according to the budget sanctioned by the appropriate authority.

(iii) To see that payments have been properly classified into capital and revenue.

(iv) To produce maximum results to the public with minimum input.

(v) To ensure that financial operations of all government undertakings are in public interest.

(vi) Finally, to make sure that public funds are not misused.

Comptroller and Auditor General of India (C&AG)

The Comptroller and Auditor General of India (C & AG) is a constitutional authority. Articles 148 to 151 of the Constitution of India are relevant here.

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(i) The C & AG shall be appointed by the President. He shall only be removed from the office in like manner as a judge of the Supreme Court.

(ii) The C & AG shall administer oath according to the form set out for the purpose in the Third Schedule.

(iii) The salary and other conditions of his service shall be determined by Parliament by law.

his control by treasuries, offices or departments responsible for the keeping of such accounts, and

(b) For keeping such accounts in relation to any of the matters specified in clause (a) as may be necessary.

(ii) To prepare and submit accounts to the President, Governors of States and Administrators of Union Territories having Legislative Assemblies.

2. Duties relating to audit

It shall be the duty of the C & AG –

(i) To audit and report on all expenditure from the Consolidated Fund of India and of each state and of each union territory having a legislative assembly and to ascertain whether the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority, which governs it;

(ii) To audit and report on all trading, manufacturing, profit and loss accounts and balance sheets and other subsidiary accounts kept in any department of the Union or a State.

3. Duty as regards grants or loans given to other authorities or bodies

Where any grant or loan given for any specific purpose from the Consolidated Fund of India or of any State or of any Union territory having a legislative assembly to any authority or body, not being a foreign state or international organisation, the Comptroller and Auditor General shall scrutinise the procedures by which the sanctioning authority satisfies itself as to the fulfilment of the conditions subject to which such grants or loans were given and shall, for this purpose, have right of access, after giving reasonable previous notice, to the books and accounts of that authority or body.

II. Based on Timing and Scope of Audit Procedures

On the basis of timing and scope of audit procedures, audit may be of continuous audit, internal audit, interim audit, final audit or periodical audit, and balance sheet audit.

1. Continuous Audit

In continuous audit, the auditor or his staff attends and checks the accounting data regularly at appropriate intervals. It is also called *running audit.* In the words of Spicer and Pegler "a continuous audit is one where the auditor's staff is occupied continuously on the accounts the whole year round, or where the auditor attends at intervals, fixed or otherwise, during the currency of the financial year and performs an interim audit. Such audits are adopted where the work involved is considerable, and have may points in their favour, although they are subject to certain disadvantages".

Suitability: Continuous audit is suitable for big organisations where business is extraordinarily large; numerous transactions of varied nature take place; and monthly or quarterly final accounts are required for managerial decision making throughout the year.

Advantages of Continuous Audit

Continuous audit is advantageous in the following respects.

(i) **Detailed examination of accounts is possible:** The auditor gets sufficient time at his disposal. It enables him to undertake detailed and exhaustive checking of the accounting records and related documents.

(ii) **Errors and frauds are detected easily and immediately:** Books and records are checked and verified immediately after the entries have been made. So, errors can be spotted and rectified quickly, frauds can be detected early before they attain alarming proportions.

(iii) **Continuous audit facilitates preparation of interim accounts:** Some companies follow the practice of paying interim dividends to their members. In such cases, interim accounts can be prepared in time to decide on payment of interim dividend.

(iv) **Audit work is properly planned:** An auditor can plan his audit work systematically by spreading his work evenly throughout the year. It improves efficiency in audit work.

(v) **Continuous audit provides for ready reference:** Audit work is carried out throughout the year to keep the books of accounts up-to-date. The audited financial statements are available to the owners, shareholders or any other authority for their ready reference.

(vi) **It is possible for auditor to give valuable suggestions:** Auditor remains in touch with the business. So he is familiar with the technicalities and intricacies of clients business. Clients can get valuable suggestions from the auditor.

(vii) **It acts as a moral check on the staff of the organisation :** Frequent visits of the auditor to the business concern would compel the staff to keep the records up-to-date. They do not dare to commit any fraud easily. It is a good moral check on any the dishonest practice.

Disadvantages of Continuous Audit

Continuous audit suffers from limitations.

(i) *There is a possibility that the client's staff may deliberately alter the figures after an auditor has checked them:* In continuous audit, the auditor checks the books of accounts in several visits. There may be deliberate alteration in figures after an auditor has checked them. Without further rechecking of records, fraud and error cannot be detected.

(ii) *Continuous audit is comparatively more expensive*: The auditor makes several visits and performs a thorough examination involving more time, effort and money. So it is not viable for small concerns.

(iii) *Continuous audit causes inconvenience to client's staff*: The auditor makes frequent visits to the organisation. His regular checking of books of account may dislocate his client's work and cause inconvenience to him.

(iv) *There are chances of negligence on the part of auditor as well as client's staff*: Client's staff and auditor may develop a social relationship due to frequent visits of audit staff. This may cause both auditor's and client's staff becoming negligent in performing duty.

(v) *Continuity of audit work may suffer:* In continuous audit, work is performed in several visits. So, the auditor may lose the thread of work and may fail to seek clarification of the queries that arose in previous visits.

Precautions

Some precautionary measures may be taken to overcome the limitations of continuous audit.

(i) The auditor should instruct the client's staff that they should not make any alteration in the records after their checking is over.

(ii) Use of secret ticks in different colours in the course of checking will enable the auditor to ensure that no unauthorised alterations are made in records. It will also facilitate continuity of audit work.

(iii) Chances of manipulating impersonal accounts are more. So, they should be checked at the end.

(iv) By preparing and referring to notes and checklists on each visit, an auditor can avoid alterations of figures in the records.

(v) A detailed audit programme should be prepared.

(vi) Important total and balances may be noted by the auditor for their comparison on subsequent visits.

(vii) The auditor should ensure rotation of work. No audit clerk should be allowed to check an account from the beginning to the end.

(viii) Queries which are not properly answered must be noted in audit notebook.

(ix) Nominal accounts may be checked by a senior clerk who has not participated in the checking of the subsidiary books.

(x) Audit work should be allocated among staff in such a way that it does not become monotonous.

(xi) Surprise visits are desirable. The auditor should not inform the date of visit in advance.

2. Internal Audit

An audit is conducted within the organisation by an internal auditor appointed by the management of an enterprise. Salaried officials of a firm known as *internal auditors* conduct audit throughout the year.

Large business organisations set up an internal audit department to exercise an independent appraisal function within the organisation. The department undertakes examination and evaluation of various accounting, financial and operating activities of the business enterprise. It highlights the weak areas in the organisation besides assisting the management to discharge its responsibility effectively. It also assists the external auditor in fixing the extent of necessary tests.

The aims of internal audit are to

(i) ascertain whether all the prescribed rules, regulations, policies, procedures and principles have been followed or not.

(ii) check whether the internal controls are adequate and effective and how well does it fit the size of the business.

(iii) ensure that all the assets of the organisation are protected against misuse.

(iv) highlight the weak areas of the organisation and give suggestions to strengthen them.

(v) Ensure that the working of the organisation is smooth, effective, efficient and economical.

In concise, internal auditing is an extension to activity of an external auditor.

Statutory audit	Internal audit
1. Statutory audit is compulsory under the law.	1. Internal audit is not a statutory requirement.
2. The objective is to ascertain the reliability of financial records to establish the true and fair view of the organisation's state of affairs	2. It aims to review the accounting, financial and other operations of the business with a view to improve the overall efficiency.
3. It is an independent financial audit by an independent auditor appointed by the shareholders.	3. Internal auditors are generally employees of the organisation.
4. They must be qualified chartered accountants.	4. They need not necessarily be qualified chartered accountants.
5. Statutory audit safeguards the interest interest of both shareholders and third parties.	5. Internal audit serves the needs of the management of the organisation.
6. Statutory auditor reports to shareholders.	6. Internal auditor reports to the management of the undertaking.

Interim Audit

Interim audit relates to an interim period and not to the full accounting year. It is conducted between two regular audits. Its objective is to know the reliability and accuracy of financial statements of a business for a part of the year. Directors want to know the figure of profit to pay interim dividend. Because dividend can be paid by the company only out of its profit and profit for a particular year shall be determined only after the completion of the year.

Advantages of Interim Audit

The following are the advantages of interim audit.

(i) Interim audit facilitates the final audit to be completed smoothly and speedily.

(ii) Interim audit spares more time to review the systems and procedures thoroughy. So, there is scope for indepth audit.

(iii) A detailed review of internal control system is possible.

(iv) Auditor's suggestions can be incorporated quickly.

(v) Errors and frauds can be identified and rectified at an initial stage and their recurrence can be prevented.

Disadvantages

Interim audit suffers from certain demerits.

(i) Alterations can be made in figures and accounts after the interim audit is over.

(ii) Certain accounting statements need to be finalised before interim audit is undertaken. The work load of the staff, therefore, increases.

Interim Audit Vs. Internal Audit

Interim Audit	*Internal Audit*
1. Interim audit is undertaken by an independent auditor	1. Internal audit is conducted by the internal staff of the enterprise.
2. Interim audit can be initiated at any time during the financial year.	2. Internal audit is part of routinework.
3. Interim audit is conducted for some specific or interim purpose	3. Internal audit relates primarily to accounting and financial matters.

Interim Audit vs. continuous Audit

Following are the differences between interim audit and continuous audit.

Bases	*Interim audit*	*Continuous audit*
1. *Period*	Interim audit covers only a part of accounting year.	1. Whole financial year is involved.
2. *Object*	It is to ascertain or check the profit or loss for a given period.	2. It is to examine the accounts and records for the whole year.

3. *Trial balance preparation*	Trial balance must be prepared and checked at the time of interim audit.	3. Trial balance is prepared after the completion of the accounting year under audit.
4. *Balance Sheet items*	Verification of assets and liabilities is undertaken at the time of interim audit.	4. Assets and liabilities are verified at the close of the financial year.
5. *Scope*	A detailed and extensive checking of books of accounts is not done.	5. The scope of continuous audit includes a detailed and extensive checking of books of accounts.
6. *Timing*	It is between final audit and continuous audit during the whole of trading.	6. It occurs at regular intervals say weekly, fortnightly or monthly.

4. Final Audit or Periodical Audit or Annual Audit

The final audit takes place only at the end of the financial year. The audit work commences after all the accounts are closed and trading and profit and loss accounts and balance sheet are ready. The auditor completes the entire work at one stretch.

Final audit is advantageous to small concerns. But in case of large concerns, it takes more time to check accounts and submit reports. So, the final audit is not sufficient for big business.

Advantages of Final Audit

Final audit is advantageous in certain respects.

(i) Full facts relating to the accounting year under review are available for audit.

(ii) Work can be completed only in one session without dislocating routine work.

(iii) It is less expensive and suitable for small concerns.

(iv) Chances of manipulation and alteration of figures after they have been checked are far less.

(v) Work can be allocated easily according to time schedule.

Disadvantages

Disadvantages of annual audit are of the following:

(i) It is unsuitable for large concerns

(ii) Indepth checking is not possible. Errors and frauds may remain undetected.

(iii) Audited accounts may not be available immediately after the close of the year.

Vouching-Its Meaning and Importance

Vouching is the essence of auditing. An independent audit aims at determining whether the financial statements fairly represent the actual financial position and the working results of the organisation. This is known as expression of expert opinion on accounts. To express such opinion, the auditor has to ensure the accuracy and authenticity of all the transactions recorded in the books of account. For this purpose, the truth of all the entries passed in the books is tested.

Meaning and Definitions of Vouching

A voucher is a documentary evidence in support of entries made in the records. Vouching is the examination of documentary evidence supporting and substantiating a transaction. Thus, vouching is a method of examination with the help of documentary evidence in order to ascertain the accuracy of the transaction recorded in the books of account.

A few definitions of vouching follow:

1. By vouching is meant the verification of the accuracy and authenticity of transactions as recorded in the books of account.

   – B.Bose

2. Vouching is a technical term, which refers to the inspection by the auditors of documentary evidence supporting and substantiating a transaction.

   – Ronald A.Irish

3. Vouching consists in comparing entries in the books of account with documentary evidence in support thereof.

   – Lawrence R.Dicksee

4. The examination of documentary evidence in support of entries is often referred to as vouching.

   – R.K.Mautz

5. Vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of receipts with the transactions of a business, together with documentary and other evidence of sufficient validity to satisfy an auditor that such transactions are in order, have been properly authorised and are correctly recorded in the books.

–F.R.M. De Paula

On the basis of the above definitions, it may be concluded that vouching is a technique of verification. It not only substantiates a transaction with documentary evidence but also ensures that these evidences are adequate, reliable, authenticated and really related to business.

Vouching Vs. Routine Checking

Vouching is a broad term and includes routine checking . Routine checking is the checking of castings, sub-castings and ledger posting. The object is to verify the arithmetical accuracy of the entries and to ensure that ledger accounts have been correctly balanced.

The following are the differences between vouching and routine checking.

Vouching	Routine Checking
1. Vouching Comprises routine checking.	Routine Checking is included in vouching.
2. Vouching is verification of transactions with documentary evidence.	Routine checking comprises checking of casts, sub-casts carry forwards and other calculations of the books of original entries and ledgers.
3. The Object of vouching is to examine the documentary evidence supporting the transactions, authenticity of the transactions and the accounting treatment.	The object of routine checking is to verify arithmetical accuracy of the entries and to ensure that ledger accounts have been correctly balanced.
4. Fraud through complicated errors and errors of principle are detected through vouching.	Ordinary errors and frauds are detected through routine checking.
5. Vouching calls for application of knowledge and skill.	Routine checking is mechanical and requires no skills.

Objectives of Vouching

Vouching achieves the following objectives .

1. To examine the accounting entries recorded in the books of account with documentary evidence in support thereof.

2. To verify the accuracy, adequacy and credibility of documentary evidence.
3. To ensure the authenticity of the transactions recorded.
4. To ensure that no transaction remains unrecorded in the books of account.

Extent of Vouching

The extent of vouching could be complete check or test check. In the presence of a sound internal control system, the auditor may restrict vouching to a test check. If the system of internal control is loose or is absent, the auditor will be running risk if he does not carry out vouching in full.

Points to be Considered at the Time of Vouching

The following points must be borne in mind at the time of conducting vouching.

i) The client should produce to the auditor all the vouchers arranged in the order in which entries appear in the books of account.The auditor should see that every voucher is passed by some authorised official.
ii) The dates given on the vouchers should fall in the year under review.
iii) The auditor must be satisfied with the head of account debited or credited from the available documentary evidence.
iv) Transactions must relate to the business. The vouchers in the personal names of the partners, managers, secretary, directors etc., should be given extra care.
v) Vouchers for an amount exceeding Rs.5,000 should bear proper revenue stamp.
vi) Items that require further classifications or evidence should be taken note of.
vii) The amount of voucher should agree both in words and figures.
vii) Any alterations made on the receipts and vouchers should be enquired into.

Vouching–in–depth

Vouching-in-depth is differently referred to as audit-in-depth, *system audit* and *transaction audit*. It is checking of accounting system in use in depth. A step by step examination or checking of all the transactions recorded in the books of account is undertaken. A more detailed and comprehensive checking is done of transactions. But it does not mean that the audit work is not on a test basis . In fact, vouching -in-depth combines both sampling and procedural check. In large concerns, detailed examination of all the records is not possible.

This technique is relied on in organisations where an effective internal control system exists.

Under vouching-in-depth, an audit sample of transactions from one area of accounting is selected and it is traced from its origin to the conclusion and vice versa. In this process, the auditor should be convinced that the laid down procedures have been properly followed. The examination may cover detailed checking of records of a particular period spread over a long time. The number of items involved may increase or decrease as per the needs. The procedures to be adopted in this regard must be flexible to suit the needs of the client. In an audit, vouching-in-depth may not be possible in respect of all the transactions. Thus, in depth examination needs to be selective depending upon the reliability of the internal check system and accounting procedures followed in the organisation.

Importance of Vouching

Vouching is the backbone of auditing. It is through vouching that an auditor can satisfy himself about authenticity and completeness of the transactions recorded in the books. The whole success of an audit depends upon the intelligence and thoroughness with which vouching is done.

The institute of Chartered Accountants of India states that the auditor should obtain sufficient competent evidentiary matter to base his opinion on financial statements examined by him.

Through vouching ,an auditor satisfies himself of the following :

i) The documentary evidences available in order are of enough validity.

ii) The transactions as recorded in the books of account did really take place.

iii) A competent official has duty authorised the transaction.

iv) The transactions wholly and exclusively relate to the business under audit.

v) The effect of transaction is correctly recorded in the books of accounts in compliance with accepted principles of accountancy.

Vouching is one of the most powerful tools in the hands of auditors. It is key to successful auditing. All the entries seem to be innocent. If the entries are traced to their sources, truth and genuiness of the transactions can be confirmed.

The auditor is not merely concerned with establishing the arithmetical accuracy of the transactions. He needs to go beyond them and statisfy himself that the entries are accurate, duly authorised and relate to the business.

Any discrepancy with regard to fictitious payments can be traced out only when related vouchers are examined carefully. If vouching is carried out with due care, even cleverly committed mistakes will come to lime light.

Armitage vs.Brewer and Knott (England 1933) stressed the importance of vouching in auditing. In this case, the auditors failed to exercise reasonable care and skill in vouching the wage sheets. Consequently, manipulating wage records and petty cash vouchers could not be detected. It was observed that "a good many documents were suspicious on their face and called for enquiry."

Entries should be checked with related vouchers to ascertain the genuiness and validity of supporting vouchers.

In the light of the points discussed above, it is clear that vouching is essence or backbone of auditing. At the same time, it is incorrect to say that vouching is three-fourths of auditing.

Voucher

A voucher is a piece of paper or a document that confirms the truth of a happening in the field of accountancy. It confirms either payment or receipt of money.

The voucher is an evidence of occurrence of a transaction recorded in the books of account. The auditor has to rely upon vouchers in order to form an opinion about the accuracy and authenticity of the recorded transactions. All vouchers should be carefully filed and preserved for vouching transactions.

Types of Vouchers

Vouchers may be of two types, *primary* and *collateral.* Primary vouchers refer to the written evidence in original. Invoice for purchase bills, contracts are some instances of primary vouchers.

Collateral vouchers are produced to the auditor when original ones are not available. Carbon copies of cash memo, copies of purchase order are presented as collateral vouchers in the absence of original ones.

The following are some of the examples of various types of vouchers to be produced to the auditor for the inspection of transactions.

Transactions	Supporting Vouchers
1. *Cash Receipt*	Carbon copies of the receipts issued, cash memo, correspondences, contract, minutes, counterfoils etc.
2. *Cash Payments*	Invoices, demand notes, bills, wage sheet, salary register.
3. *Purchases*	Copies of purchase order, original invoices, goods received notes, correspondence, goods inward book etc.

Vouching of Cash Transactions

Cash is the most liquid asset. It is potentially attractive to defalcators. Because of its high vulnerability, vouching of cash transactions has assumed enormous significance.

General points to be considered while vouching cash transactions

The auditor should keep in mind the following considerations while vouching cash transactions.

1) A reliable system of internal check is in force

The auditor should test the effectiveness of the internal control system followed in the client's organisation. In the absence of an effective internal control system, chances of misappropriation of cash are more. He should ensure that all cash receipts are accounted for and all payments are authenticated. The internal control needs to be revised periodically and suitable modification is done to make it more effective.

2) The auditor should verify and test the system of accounting

The system of accounting should be tested for its accuracy of recording cash transactions. By suppressing the receipt of cash and overstatement of payments, fraud can be committed.

3) The auditor may test check a few items at random

As far as practicable, all cash transactions should be checked elaboratley. However, an elaborate checking may not be needed, if there is an efficient system of internal check. A few items may be checked at random if he is convinced that transactions are free from irregularities.

4) All the items noted in the rough cash book are promptly and properly entered in cash book

Entries made in the rough cash book should be carefully checked with the main cash book to detect whether there is any error or irregulartity.

5) The method adopted for depositing daily cash receipt in bank is satisfactory

The auditor should ensure that all cash receipts are deposited in the bank on daily basis and supported by pay-in-slips. Accounting of receipts should not be delayed. Adjusting customer's account with allowances and rebates are not actually allowed. Misappropriation of cash is possible to the extent of adjustment.

6) A bank reconciliation statement may be prepared

The auditor should prepare a bank reconciliation statement verifying the bank balance with cash book and pass book. Reasons should be found out for the difference in amount between the bank balance as per the pass book and that of in the cash book.

7) Cash in hand should be verified

The auditor should verify the cash in hand by actually counting it. He should see that the amount of cash held in hand tallies with the cash book balance.

8) Receipt books should be under the custody of some responsible staff

The auditor should ensure that the receipt books are kept under the control of some responsible staff and all recepits bear serial numbers. Carbon copies of the same should be kept in the office. The control over recepit book should be proper.

VOUCHING OF CASH RECEIPTS

The debit side of cash book shows opening balance, cash sales, receipts from debtors, income from interest, dividend, rental income, commission received, subscriptions, sale of investments, bill receivable, bad debts recovered, insurance, claims, receipts from hire purchase, sale of fixed assets and miscellaneous receipts etc. Each item of recepits is discussed briefly.

1) Opening Balance

The first item to be checked on the receipt side of the cash book is opening balance. It should be checked with the balance shown in the audited balance sheet of previous year. Working papers may be referred to see that the closing balance of the cash recorded in the balance sheet is the result of many balances.

Evidences to be vouched include previous year's balance sheet and cash book.

2) Cash Sales

Chances of fraud are greater under this head. Sufficient care should be taken to vouch documentary proofs in support of sales. Various copies of cash memo salesmen's diary, cashier summaries, counterfoils of receipt book etc., come under check.

Generally, carbon copies of cash memos or cash sales invoices would support entries for cash sales. The cash register will carefully be checked with the carbon copies of cash memos. Daily deposist of cash received in the bank should be verified. Dates of cash memos and dates on which receipts are entered should be the same. Cash memos cancelled if any should be kept in the book. Where automatic bills are in use, the entries in the cash biook should be checked from bill records. Where automatic cash register is maintained, the auditor should resort to the summaries.

A test check with the goods outwards books may be conducted. The exent of such test check will depend upon the efficiency or otherwise of internal control in operation.

3) Collection from Debtors

Vouchers to be checked include correspondence with debtors and counterfoils of receipts.

The counterfoil receipts or carbon copy receipts in support of cash receipts should be checked first. All the receipts should deposited in the bank in the immediate following day. Allowing discount to customers should be enquired into. It should be ensured that discounts allowed are at uniform rate.

Due authorisation is obtained in case of higher discounts. The amount due from an insolvent customer can be claimed through his official receiver. The correspondence with the official receiver and the statement received from him should be carefully verified.

The auditor can contact the customers directly and ask for their confirmation of balance.

In collection from debtors, two types of frauds are possible.

Teeming and lading or lapping

Lapping is concealment of a shortage by delaying the recording of cash receipts. The amount collected from one customer is misappropriated by the cashier and the customer account is adjusted with the amount collected from some other customer. Such adjustment can go for a long period, if the internal control system in use is not effective.

Writing off as bad debts

The amount collected from customer may be misappropriated. To conceal such misappropriation, the amount standing to the debit of the customer account is written off as bad debts. The auditor should carefully examine cash receipts from customers in order to ensure that no fraud of any nature is committed.

To prevent malpractices, the following steps are needed.

i) Internal check system should be studied.

ii) Persons maintaining debtors ledger should not be allowed to collect money from customers.

iii) Carbon copy of the receipt or the counterfoil receipt should be compared against pay-in-slips.

iv) All bearer cheques received should be immediately crossed as 'account payee only'.

v) The cheque number must be mentioned on the carbon copy receipt or counterfoil receipt.

4) Income from Interest

The vouchers to be checked include passbook, bankadvice, counterfoils, etc. Depending upon the nature of interest received, evidences are avaiable for vouching. Interest income may be received on fixed deposits in bank, savings bank account, loans granted, securities held, etc. Interest received on fixed deposits in the bank should be verified with the bank advice. The arithmetical accuracy of such interest calculation should also be verified.

Interest on savings banks account should be vouched with bank advice. Interest on loan granted by the client organisation should be vouched with reference to the loan agreement with the borrower. The terms on rate of interest, date of payment etc. should be checked.

Interest received on securities should be checked with reference to securities, correspondences made, covering letter, counterfoil receipts, etc., should be examined.

5) Dividend

Vouchers to be verified include counterfoils, dividend warrant, passbook etc.

Dividend received should be verified with the counterfoil or upper part of the dividend warrant and with the letters received along with the cheque for the amount of dividend.

Where, shares have been bought cum-dividend or sold ex-dividend, broker's note should be checked. This is to ensure that dividends due on those have been received later on.

Where the dividend warrant received is not yet collected, it should be shown as cheques yet to be collected.

6) Rental Income

Vouchers with regard to rental income include

- rent rolls,

- lease deed and agreements,
- counterfoils,
- correspondence with clients, etc.

Rental income may be received in respect of short term or long term leasing of real estates, plant and machinery, construction equipment, etc.

The auditor's role consists of verifying the rent rolls with the rent received. If the rent is collected through an agent, agent's statement of account must be examined. The auditor should see that proper adjustments are made for rental income accrued but not due. Entries should be made in cash book immediately and everyday collections should be deposited in the bank the next day.

7) Commission

Documents to be verified include carbon copy of receipts book, agreement between the client and the party, etc. Commission is received for rendering service or labour in discharge of certain duties. It may be payable as a fixed percentage of the price or amount of business transacted. Commission received should be checked with the amount entered in the cash book. The accuracy of the third parties regarding rate of commission and basis of the working should also be verified.

8) Subscriptions

The vouchers to be verified are: Counterfoil, register of subscribers etc.

A subscription is a contribution towards a fund maintained by a society, club or school. The auditor can ensure the entitlement of the receipt of subscription by going through the bye-laws of association or club.

Subscriptions received should be checked with the register of subscribers and counterfoils of the receipt. The auditor should see that subscription due but outstanding is accounted for. Any unusual amount of subscription should be enquired into.

9) Sale of investments

- Documents to be verified include
- minutes of board of directors
- bank advice, etc.
- Investments through broker. A broker issues a note on details about the nature of investment sold, the terms of sale, mode of payment, etc. It is known as *'broker's sold note'*.

So, the sale of investments should be vouched with broker's note. If the sales proceeds of investments are received through bank, then the bank advice should be examined. The fact that the sale is ex-dividend or cum-dividend should be carefully verified. In cum-dividend sale, element of income by way of dividend and amount attributable to investments should apportioned. Minutes of board of directors also need a careful examination of facts. The tax implications relating to capital gains arising out of the sale deserve due attention.

10) Bills Receivable

The documentary evidences available for inspection include cash book, pass book, bills receivable book, etc.

The amount received on the bills should be debtors in the bills receivable account and credited in the sundry debtors account.

Amount received against the bill should be verified with the bills receivable book, cash book and bank statements.

Bills accounted as dishonored might give way to misappropriation of funds. The possibility of such fraud should be examined. Dishonoured bills will be made available to the auditor. If not available, it is a clear cut case of fraud.

Similarly, bills discounted should be duly accounted for. If discounted bills have not matured on balance sheet date, a foot note as to contingent liability should be there.

11) Bad Debts Recovered

The vouchers to be inspected are correspondences between the official receiver and the client, dividend warrant, counterfoil receipt, credit manager's file etc.

Amount found to be irrecoverable is written off as bad debts. Receipts from debtors who have become insolvent should be vouched with the dividend warrants received from the official receiver or assignee.

Details of total debt and rate per rupee payable as dividend should be examined. The auditor should ensure that the amount recovered is deposited in the bank.

12) Insurance Claims

The vouchers in support of insurance claims received are the policy of insurance, correspondence with insurer, FIR in case of theft, accident etc. and the report of the valuer or assessors.

The calculation of the amount claimed should be verified. The amount received should match with the forwarding letter sent by the insured. The auditor should see that the amount received is deposited in the bank. Any dispute regarding the

claim should be ascertained. Expenses incurred towards repairs or renovation should be properly accounted for the books of accounts. After the receipt of the full settlement of claim, the loss should be appropriately treated in accounts.

13) Receipts From Hire Purchase

Documents such as hire purchase agreements and evidence in the nature of counterfoils of receipts are to be vouched.

The auditor can know about amount of instalment, number of instalments, hire purchase period and other related terms by studying the hire purchase agreements in detail. The auditor should keep in mind that instalment includes interest also. He should check that the whole amount of instalment is not credited to sales account.There should be bifurcation.

14) Miscellaneous Receipts

The documents to be verified are:

- Fixed asset register
- Sales deed
- Auction notes
- Broker's sold note
- Minutes of directors
- Correspondences exchanged etc.

Sale of fixed assets by companies should be approved by the board of directors. Therefore, the minutes of the meeting of directors are to be verified.

To ensure that the sale proceeds are deposited in the bank on the very next day, the auditor should verify the cash book, entries on sale of fixed asset and also the bank book. Calculations of profit or loss on sale of fixed assets should transferred to capital reserve.

15) Miscellaneous Receipts

Miscellanous receipts should be vouched with the correspondence, contracts or any other related documents produced in support of the transactions.

VOUCHING OF CASH PAYMENT TRANSACTIONS

Having vouched the receipts side of the cash book, the auditor proceeds to vouch the cash payments. Before vouching payments, he should evaluate the internal control system in use as regards payments. The objects of vouching payment side of the cash book are to

i) Ensure that the payments were properly authorised

ii) Ascertain that they are recorded under appropriate heads

iii) Ensure that the payments were exclusively and wholly for the business.

iv) See that payments were supported by proper documentary evidences.

v) Ascertain the closing balance at bank and cash in hand accurately.

While vouching evidences of payments, the following points must be taken into consideration.

i) The payment is made for the business itself.

ii) The payee's name is correctly entered in the cash book.

iii) The payment relates to the period under audit.

iv) The date in the payee's acknowledgment should agree with the corresponding entry in the cash book.

v) The payment is properly sanctioned by the responsible person.

vi) The correct amount of the payment is entered under appropriate head.

vii) It bears proper revenue stamp.

Vouching of payments such as cash purchases, cash paid to creditors, wages, salaries, capital expenditure, investments made, hire purchases and instalment payments, travelling allowances, insurance premium, freight and carriage, deferred revenue expenditure, dividends, postage and telephone expenses, bills payable, taxes, directors fees and miscellaneous expenses are discussed.

1) Cash Purchase

Vouchers to be inspected are cash memos, goods inward book, etc.

Cash memos furnish details about the quantity bought, rate per unit, discount allowed and net amount paid.

The quantity mentioned in the cash memo may be verified with goods inward register and stores ledger. The general market rate should be compared with the rates at which purchases were made. Only the net amount mentioned in the memo should have been paid.

The auditor should ensure that all payments have been properly authorised by a responsible officer.

2) Payments to Creditors

Documents available in respect of payments made to creditors include

- Invoice
- Purchase return notes
- Counterfoils of cheque book
- Statement, correspondence with creditors

- Purchases orders and agreements
- Goods inward book
- Mintutes of directors etc.

Entries for payment to creditors should be vouched with receipts, counterfoils of cheques and bank statements. The auditors should be satisfied with the system of internal control for payments to creditors. He should see that all payaments are approved by a responsible officer. The auditor should ensure that creditors have allowed discounts as agreed upon. Creditors' ledger balances should be verified with the written confirmations received from creditors.

3) Wages

The documents to be verified are:

- Wage sheet
- time card, piece card, job card, etc.
- register for engaging casual works.
- records maintained in personnel department

Before vouching the amount of wages paid, the auditor should enquire into the adequacy or otherwise of the system of internal control in force.

The following points will be considered while vouching wages:

i) Casts and cross casts of the wage sheet, pay rolls should be checked and the amount should be verified with cash book.

ii) All the persons responsible for preparation of wage sheet have signed the wage sheets.

iii) It should be ensured that no dummy workers are included in the wage sheet. A cross verification of wage sheet with the records maintained in the personnel department, provident fund members list, ESI cards etc., would help find out discrepancy in this regard.

iv) Time keeping records and piece work records be verified with the wage book.

v) The basis of payments (daily, hourly or piece work rates) should be enquired into.

vi) The thumb impression or signatures on receipts of various months should be checked. Wages paid for various months should be compared. If wages paid are found very high, the auditor should enquire into reason for such variation.

vii) The total amount of wages paid should be checked with the amount of the cheque drawn.

viii) All unpaid amounts should be traced into unpaid wages register.

ix) Payment of overtime wages and payment of wages to casual workers should be properly authorised by a responsible official.

4) Salaries

The vouchers to be verified are

- Salaries register
- Appointment letter
- Counterfoils of cheques
- Bank statements, etc.

The auditor should evaluate the system of tnternal control as regards payment of salaries. While vouching the documents produced to him, he should take the following into consideration.

i) Casts and cross cast of salaries should be verified with the cash book.

ii) The cheque drawn should agree with the salaries register.

iii) The salary acquittance roll should be signed by a responsible official.

iv) Any increment in the salary should be sanctioned by an appropriate authority.

v) Deductions on account of provident fund, income tax etc., should be checked.

vi) Salaries paid to senior employees should be checked with service contracts and entitements.

vii) The entries in the cash book and journal should be vouched with the salaries roll.

viii) Any payments not included in salary but paid separately should be supported by a cash payment voucher duly signed by the recipient.

ix) The auditor should compare the salary figures of the past years with that of current year. Reasons for variance should be analysed.

5) Capital Expenditure

Capital expenditure is the amount spent on acquisition of fixed assets. The documentary evidences in support of incurrence of capital expenditure are

- Invoices
- Agreements
- Letters of contracts
- Receipts

- Broker's bought note
- Deeds
- Lease agreements
- Auctioneer's note, etc.

The procedures for vouching various items of capital expenditure are discussed.

1) Purchase of free holds and leasehold property

In purchase of freehold property, conveyance deed is prepared. The agreement for sale together with the title and conveyance deed should be vouched for the real property.

If the purchase is through a broker, broker's bought note should be verified. All the legal charges incurred on the acquisition of the property and brokerages paid should be capitalised. The architect's certificate contract for construction and payee's acknowledgment should be examined in relation to constructed property.

In case of leasehold purchases, the auditor should examine the terms and conditions of the lease agreement. Payments made for lease hold property should agree with the terms of agreement. Receipts issued by the lessor should be verified. All expenses connected with lease hold purchases should be debited to leasehold land account.

2) Purchase of plant and machinery

The auditor should vouch the receipts and invoices received from the vendors. The expenditure incurred till the installation of machinery on the premises should be capitalised. If it is purchased from auction, the auctioneer's account should be examined. In case of imported machinery, any importing duty and clearing charges met should be debited to the asset account. The amount paid should be checked with the contract bills rendered by the contractor and payee's acknowledgment.

3) Purchase of investment

The auditor should examine broker's bought note and receipts. The securities themselves should be examined. For investment made in existing shares, share certificates should be verified. Payments made through the bank should be verified with the pass book. It should be ensured that purchase of investments has been properly authorised.

Investments consisting of incribed stock should be checked with certificate obtained from the bank. All investments must be in the name of the company. Where investments are purchased at cum interest, interest included in the purchase

price should be debited in the interest account and the balance in investment account. When interest is received on investment, the same should be credited to the interest account.

4) Purchase of motor vehicles

Contract of purchase, invoice, broker's note, payee's acknowledgment, asset receiving report and the registration book showing the ownership in the name of the client should be verified.

5) Purchase of patents and copyrights

Patents are the exclusive right or privilege to make or produce something. For example, a formula for bottling a soft drink. Copyright is a right to produce an item of a particluar design. The acquistion of patent and copyright should be verified with receipt issued by seller. If the purchase was through an agent, the statement of agent's account should also be examined and his commission be capitalised. But renewal fees are not to be capitalised.

6) Payments under hire purchase and instalment agreements

Hire purchase agreements or agreements to pay instalments should be examined. The receipts received from hire vendors should be seen. It is essential to see that instalments paid include interest also. The interest portion should be charged to revenue. Care must be taken to see that interest is not debited to the asset account. Periodical statements received from the hire vendor should be vouched for their authenticity.

7) Travelling allowances

Travelling allowances are a fixed amount paid to meet travelling expenses incurred by employees. The vouchers to be checked are bills, payee's acknowledgement, receipt etc. The travelling allowance bill should be verified with the rules and the calculation of the allowance may be certified. Payee's acknowledgement should also be checked. Exsisting rules for payment and service rules have to be examined.

8) Insurance premium

The auditor has to examine vouchers like insurance policy, demand letter from the insurance company, premium paid certificates, receipts etc. The policy can either be a new policy or renewal of an old policy. Premium paid on new policy should be vouched as follows.

- Verify the actual policy to ascertain its nature.
- Verify the demand letter issued by the insurer.

See the official receipt acknowledging the receipt of premium by the insurance company.

In case of first premium paid, the auditor will examine a note of the premium paid available in the policy document itself.

In case of old policy, the renewal receipts will be verified with demand note. If any policy has lapsed during the year, the auditor has to take note of the reasons for such lapse. The entries in the cash book relating to premium paid are to be vouched with receipts. Premium paid, if it relates to the period beyond the year under audit, should be disclosed in the balance sheet.

9) Freight carriage and custom duty

The railway freight should be verified with railway receipt which would be issued by the railway. Any payment made against "freight paid" railway receipt will not be genuine one. Shipping charges paid should be vouched with statement of bills rendered by the shippers or carriers or clearing or forwarding agents together with their receipts. The documentary evidence enclosed with the bill should be examined.

Rebates allowed for prompt payment of freight of ship should be looked into. Allocation of capital and revenue expenditure should be examined.

Freight and customs duty paid for the purpose of acquiring assets should be capitalised if clearing agents are appointed and all payments are made through such clearing agents, the statements received from the said clearing agents should be verified. The original receipts of custom duties, port charges and other charges received from the clearing agent along with this statement of accounts are to be verified.

10) Deferred Revenue Expenditure

Expenditure incurred in the current financial year gives benefits in the coming years also. Commonly incurred deferred revenue expenditures are:

- Cost of shifting a business to a comparatively better locality.
- Exceptional repairs of non-recurring nature.
- Heavy advertisement expenditure the benefit of which will extend to years together.
- Heavy renovations and structural improvements to buildings.

Deferred revenue expenditure is given a special tratment. It is capitalised temporarily and written off over years for which the benefits are expected to be enjoyed. Any relevant docunentary evidences such as accounts, receipts, etc. are to examined. The amount to be carried forward is shown as an asset in the balance sheet.

11) Dividends Paid

Evidences such as dividend book, bank statements, unpaid dividend register, etc.,are to the vouched.

The auditor should go through the memorandum and articles of association to know about the rights attached to the share capital in question. Dividends should be paid in accordance with the rights of shareholders.

The nature of dividend paid must be carefully ascertained. If it is interim dividend, the auditor should see whether directors are empowered to pay interim dividend and whether profits disclosed by interim accounts justify the payment of interim dividend. In case of final dividend, the resolution passed at the shareholders meeting should be examined.

The following steps are essential to vouch the amount of dividend paid.

i) Look into the source of dividend.

ii) Verify casts, cross casts and carry forwards of the dividend book.

iii) Examine the dividend book with the returned endorsed dividend warrants.

iv) Ensure that the total of gross dividend as recorded in the dividend book with bank statements.

v) Verify the unpaid dividend with the unpaid dividend register. Any subsequent payment out of the unpaid amount of dividend should be verified.

12) Postage and Telephone Expenses

The vouchers to be verified in relation to postage and telephone expenses are receipts, postage book, cash book, petty cash book, etc.

The auditors should evaluate the efficiency or otherwise of the system of internal control in operation relating to incurrence of the postage expenditure.

Casts of the postage book along with the drawing received from cash book or petty cash book should be verified.

Bill and receipt obtained from the telephone department should be verified.

13) Bills Paybale

A good internal control system demands the cancellation of the bills immediately after the payment. This is to avoid any possibility of fraud. Payments made against the bills should be checked with the actual bills returned and duly cancelled. Payee's acknowledgement should also be verified. Bills payable register should be examined to ensure that only bills outstanding had remined uncancelled.

14) Payment of Taxes

The evidences available for tax payments include receipted challans, copy of tax return filed, notice of demand, etc.

Payments by way of income tax and other taxes should be verified with receipts challans. Tax calculations should be carefully checked. Admitted tax liability should be vouched with the receipted challan and the copy of the tax return filed. Payments against the final assessment should be verified with receipted challan, assessment order and notice of demand.

15) Director's Fees

Payment of directors fees may be verified with articles of association waiver's letter, receipts, minutes book, special resolution, attendance register etc.

The directors of a company receive fees for attending the board meetings. The articles of association and minutes of directors meeting should be examined in relation to payment of director's fees. Fees paid must be checked with the attendance register, minute book or resolution passed to the effect in the general meeting. For the commission paid to directors, the auditors should examine the agreement in order to find out the calculation of profit. Under the act, remuneration paid to directors should be shown in the profit and loss account separately. If a director has forgone his fees, the auditor should examine the waiver's letter.

16) Miscellaneous Expenses

The auditor should examine receipts, bills, correspondence, etc., to vouch the payments towards miscellaneous expenses. Th casts, cross casts and carry forwards of the cash book must be checked. Postings into the general ledgers should also be checked. Some of the postings into the subsidiary ledger should also be checked.

Vouching of petty cash book

The petty cash book is usually kept under the imperest system. The auditor should vouch the petty cash book transaction on the following lines.

i) Check the amount receivied by the petty cashier from the head cashier with reference to the cash book or bank statement.

ii) Carefully verify the casts, cross casts and carry forwards of the petty cash book.

iii) Check cautiously the validity of vouchers with relevant supporting evidences.

iv) Verify whether the cashier has signed the petty cash book at the end of each month.

v) Consult the postage book for purchases of stamps.

Vouching of Trading Transactions

Trading transactions carried out in a business concern include purchases, sales, purchase returns, sales returns, goods sent on consignment, hire purchase, sale or return, etc. Transactions are both on cash and credit basis. All credit purchases are recorded in purchase ledger. In sales ledger, all credit sales are recorded in the names of debtors. This chapter will focus on vouching of trading transactions.

I. VOUCHING OF PURCHASES BOOK

In purchases book, transactions relating to credit purchases are entered. A purchases ledger may be differently known as purchases day book, purchase journal, bought book, bought daily book or invoice book.

Vouching of purchases book ensures that all purchase invoices are entered in the Purchases Book and the goods entered in the Purchases Book are actually received and the client pays money only for those goods that are delivered by the supplier to him.

The auditor should first examine the system of internal check in force regarding credit purchases. While vouching credit purchases, the following points should be considered.

1. Purchases Invoices

While examining purchase invoices, the auditor should consider the following.

(i) Purchase invoices are prepared in the name of the client.

(ii) The names of the supplier as entered in the purchase invoice agree with the purchases book.

(iii) The dates of purchase invoices relate to the financial period under audit.

(iv) Goods mentioned in the invoice are the ones the business deals in.

(v) The trade discount received has been deducted from the invoice amount. Only the net amount after deducting trade discount is entered in the purchases book.

(vi) Purchase account has been properly initialled by those who had internally checked it. A brief note on the internal checking done by the

client's staff should be written on the back of the invoice.have been actually lost. For this purpose, he may scrutinise the relevant account of the creditor in the personal ledger. The auditor should indulge in a general scrutiny of the invoices lying to the credit of the respective creditor.

2. Allocation

A proper distinction should be maintained between capital and revenue expenditures.

3. Receipt of Goods

The purchases book should be verified with the help of purchase invoices, copies of order placed, goods received note, goods inward book and copies of challans from supplier. It should be ensured that goods ordered are actually received.

4. Inspection Reports

Sometimes, the nature of goods purchased requires an inspection report. Such report should be checked by a responsible official to ensure that liability is being recorded for the right type of goods purchased. If goods are found defective or the quality of the goods is not approved by the chemist, such value should be kept in suspense. Only after proper verification, the amount should be adjusted.

5. Tenders and Quotations

The purchase invoices should be verified with the tenders or quotations and purchase orders. Terms of purchases should be examined on the basis of the documents concerned.

6. Purchase Contracts

For bulk purchases, contracts are entered into with the supplier. Such contracts should be vouched for their accuracy on the basis on which the invoices have been prepared. It should also be ensured that any concessions available in the contract are fully availed of.

7. Authorisation

Before recording entries in the purchases book, they must be properly authorised by a responsible official. If authorisation for purchase transactions has not been obtained, its facts must be brought to the knowledge of the client.

8. Statements of Account

Statements of account may be obtained from suppliers. If statements of accounts are being received from the suppliers on a regular basis, a test check of the amount of invoices may be resorted to. The purchases invoices should agree with the entries in the statements of accounts.

16. Imports

Imports should be verified with supporting documents such as letter of credit, foreign invoices, exchange conversion rates, shipping bills, bills of entries, clear and forwarding bills, freight and octroi receipts banker's advice, bills of exchange, etc. The following errors and frauds are likely to occur while accounting for imports.

(i) Fictitious purchases may be included in the purchases book.

(ii) Same invoice may be recorded twice.

(iii) Goods purchased in one period may be omitted in that period and the same may be entered in the next period.

(iv) Purchases may be debited in one period and the goods, against such purchases may be received in the subsequent period.

II. VOUCHING OF SALES BOOK

Sales book shows credit sales only. A sound internal check is essential in respect of sales transactions. The auditor should carry out vouching of credit sales in the following manner:

1. A few Test Checks

Having evaluated the efficiency or otherwise of a system of internal check in operation, the auditor may apply a few test checks.

2. Execution of Sales Order

The auditor should study the procedures for executing sales. All the orders received from the customer directly or through agents are recorded in the order book. Then invoices are prepared with the rates agreed upon with the customers, which will be mentioned in the order book.

3. Sales Book

The auditor should verify the castings and postings of sales book and the postings to the ledger. Carbon copies of invoices should be checked and then cancelled by a rubber stamp or initials by the auditor. Cancelled ones cannot be produced again in support of another entry.

4. Sales Invoices

Sales invoices should be checked with due care.

(i) The invoice is prepared in the name of the debtor. In case of a company, there cannot be any sale by a company to itself.

(ii) The name of the debtor found on the invoice agrees with the sales book.

(iii) The date of sales invoice falls within the period under audit.

(iv) Only the next amount of the invoice (after deducting trade discount) is entered in the sales book. Trade discount is allowed with proper authority.

5. Classifying Sales

The allocation of the sales should be examined. Sales of non-trading items (sale of assets, etc.,) are not included in sales of goods.

6. Despatch of Goods

On finalising a sale with a customer, the sales department should prepare goods delivery requisition slip in quadruplicate. These slips should be pre-numbered. The original copy is retained by the sales department. Two copies are sent to the stock department. The stock department retains one copy and sends another copy along with the goods to despatch department. The last copy is sent to accounts department. On receiving the despatch note from the despatch department, the accounts department will prepare an invoice to be given to the customer. The auditor should check sale invoices with documentary evidences such as goods dispatched note, goods outward register, etc., to ensure the dispatch of goods by the company.

7. Sale Contracts

If any sale contract exists, the terms of the contract should be examined. The auditor should ensure that preparation of sales invoices is in accordance with the terms of sales stipulated in the contract. In the absence of sales contract, the sales invoices should conform to the selling policy of the management.

8. Authorisation

The sales invoices should be properly authorised by a responsible person before they are recorded in the sales book.

9. Statement of Accounts

Statement of accounis may be regularly received from the debtors or sent to debtors by the client. A test check of the amount of sales invoices with the entries shown by the statement of the accounts, may be undertaken.

10. Tenders and Quotations

Tenders and quotations may have been called for by the client. Then sales invoices should be verified with such tenders and quotations received.

11. Exports

Export transactions will be vouched with sales invoices, exchange conversion rates, shipping bills, clearing and forwarding bills, octroi and freight receipts and banker's advice for the negotiation of documents. Terms of invoice (F.O.R, F.O.B, C.I.F etc.,) should be checked with sales contracts or export orders received.

12. Forward Contracts

The auditor should carefully examine the terms of forward contracts for sale and their eventual settlement. A possible loss on the supply of goods involving future commitment must be reviewed. A provision for loss needs to be made thereof. Only the goods actually delivered should be considered as sales. It is not desirable to take a credit in advance, which is in the nature of forward sales.

13. Provisional Sales Invoices

If the auditor comes across any invoice marked provisional, he must be very careful. Relevant adjustments should be made through final sale invoices and included in the books.

14. Sales Invoices Insufficiently Vouched

The auditor should list all sales invoices which are missing, or which are not available or they remain insufficient for one reason or other. Then the list should be given to the management for clearing queries and doubts raised. Those queries which remain unanswered should be reported to the management.

15. Castings and Postings

The auditor should verify the casts, cross casts and carry forwards of the sales book. He should also check posting to general ledger and some of the postings to the sundry ledger.

16. Concealment of Sales

To detect any suppression of sales invoices, the sales book should be tallied with goods sent out in the last month of the accounting period as shown in the goods outward book. The sales invoices for the first month of the next period should be verified to ascertain whether any of them relate to the period under audit. Further, the percentage of gross profit earned on the cost of goods sold may be compared with that of the previous period. If there is any material variation between the two, the reasons for the same may be enquired into. The likelihood that goods were sent out, but the corresponding invoices were not entered in the sales book.

17. Inflated Sales

Sales may be inflated in order to project a higher profit than what it is actually. The auditor will uncover any deliberate attempt for inflation of sales.

18. Heavy Sales

If sales are abnormally high at the end of the period, the auditor should ensure that all these goods were delivered before the close of the year. None of such goods should be included in closing stock. Following errors and frauds are possible in connection with sales.

(i) Goods sent on approval or V.P.P. but not yet accepted by the customer or goods sent to the agent for sale but not yet sold, may be treated as sales.

(ii) Sale of fixed assets may be treated as sale of goods.

(iii) Next year's sales may be recorded as current year's sales.

(iv) Goods sent on consignment may be treated as sale.

(v) Fictitious sales may be recorded.

III. VOUCHING OF PURCHASES RETURNS BOOK

Goods purchased may be returned to the supplier as damaged or for reasons such as goods are not as per sample, inferior quality of goods etc. If the price of the goods has been paid already, a debit note should be sent to the supplier or credit note obtained from the supplier. If the price is yet to be paid, a note to be sent to the cash department to send lesser amount to the supplier.

1. Debit note

The auditor should vouch the debit notes issued to the creditors. The following points should be considered in vouching the debit note.

(i) Debit note is prepared in the name of the client.

(ii) The name of the creditor as entered on the credit note agrees with the purchase returns book.

(iii) The date of the debit note relates to the financial period under audit.

(iv) It has been checked by a responsible person and it bears his initials.

2. Allocation

Credit should be given to the revenue account which was previously debited.

3. Goods sent out

The entries for the goods returned should be checked with the goods outward book or gate pass.

4. Reason for return

The reasons for purchases return should be enquired into. Reasons such as goods are not in accordance with samples or of inferior quality are generally attributed for purchase returns. Where the accuracy of the entries for returns is doubtful, correspondence on the subject should be carefully examined.

5. Casts and posting

The auditor should check casts, cross casts and carry forwards of the purchase returns book. He should also examine posting to the general ledger and some of the postings in the creditors ledger.

6. Manipulation of amounts

The auditor should vouch the purchases returns of the first month and last month of the accounting year carefully so as to detect any manipulation of amounts.

There is also a possibility of manipulation of accounts by including the fictitious sales during the year under audit and showing them as returned after the end of the accounting period.

7. Statement of accounts

The auditor should verify the amount shown in the credit note. A test check of amount entered in the statement of accounts.

IV. SALES RETURNS

Sometimes, customers return goods on account over their being defective or inferior in quality. Goods returned should be entered in the goods inward book and gate keeper's returns inward book and stock register. A credit note should be prepared and sent to customers.

While vouching credit notes issued, it is necessary to consider the following:

(i) The credit note is made out in the name of the client.

(ii) The name of the debtor as entered on the credit note issued agrees with the sales returns book.

(iii) The date of the credit note relates to the financial period under audit.

(iv) The credit note has been internally checked by a responsible person. It bears his initials as a mark of internal checking done.

The goods which the customers return are included in the closing stock at appropriate value. Heavy returns at the beginning or at the end of the period should be paid attention.

V. GOODS SENT ON CONSIGNMENT

For goods sent on consignment, a separate book known as "consignments outward journal" should be prepared. This book should be verified with copies of agreement, account sale, correspondence, and proforma invoice.

Proper adjustment should be made for goods sent at higher price. The unsold goods with the consignee should not be treated as sales. They should be included in stock and shown in the balance sheet as goods on consignment at appropriate value.

VI. SALE OR RETURN BASIS

Goods are sold on sale or return basis. Goods are sold to customers on condition that if the customers do not approve of them, they can return them within a specified period.

Till the customer approves the goods they cannot be treated as sales. At the close of the accounting year, some goods may rest with the customer unapproved. Such unapproved goods should be shown on the asset side of the balance sheet as goods with customers.

"Goods on sale or Return Journal" may be used when transactions to be recorded are numerous. The journal should be vouched with evidences like correspondence exchanged, invoices etc.,

Audit of Ledgers

After the books of original entries have been vouched and postings therefrom are fully checked, audit of ledgers should be carried out. In business, personal ledgers such as *purchases* ledger and *sales ledger* are maintained to record credit transactions. In purchase ledger, all credit purchases are recorded in the names of suppliers. Similarly, in sales ledger, all credit sales are recorded in the names of debtors. A purchase ledger is also known as *sundry creditors ledger* or *accounts payable ledger.* Sales ledger is also called *sundry debtors ledger*, or *accounts receivable ledger.*

The cash book, purchase book, sales book, sales return book, purchase returns book are to be totalled periodically and the summary is posted in the general ledger.

All those entries that cannot be recorded in any other book of prime entry are recorded in journal. Opening entries, closing entries, adjustment entries, rectification of errors and entries relating to share capital are usually passed through journal.

In view of the above, different ledgers that have to be scrutinised are:

1) Bought ledger
2) Sales ledger
3) General ledger and also
4) Main journal

The bought ledger consists of creditor's accounts.

1) Purchase Ledger

A model of a creditor's account is given.

Bought Ledger
X A/C

	Rs.		Rs.
To discount	xxx	By opening balance	xxx
To return	xxx	By purchases	xxx
To bank	xxx		
To transfer	xxx		
To advances	xxx		
To bill payable	xxx		
To closing balance	xxx		
	xxx		xxx

The auditor should take into account the following points while auditing purchase ledger.

Opening balance

The auditor should check the opening balances of different accounts in the bought ledger with the previous year's audited balance sheet or the schedule of creditors duly checked during previous audit.

List of closing balances

The list of closing balances of creditors should be verified with the purchases ledger. The control account of the above ledger in the general ledger should be tallied with the total of the list of balances. The casts of the schedule of creditors should also be verified.

Confirmation of balances

The purchase ledger balances should be compared with the confirmation or statement of account received. Any difference must be sorted out.

Amounts which remain unclaimed

If any purchases made remain unpaid for a longer period, the reason for non-payment is to be looked into. If it sounds reasonable, the unpaid amount may be suggested for write off.

Disputed amounts

Certain amounts due to creditors may be in dispute. Such amounts must be shown as contingent liability and adequately provided for in the accounts.

Fictitious Credits

The bought ledger may be credited with large amount fictitiously to reduce profit. Such credits shown at the end of the accounting year should be thoroughly examined.

Debit balances

Some accounts may show a debit balance. This may be due to discount allowed by the supplier, amount due on goods returned, advance paid to the supplier or any purchase made by the supplier is wrongly accounted through the bought ledger instead of the sales ledger.

The auditor should carefully examine the reasons thereof.

2) Sales Ledger

Proforma of a sales ledger account is shown.

Customer Ledger

	Rs.		Rs.
To opening balance	xxx	By cash	xxx
To sales	xxx	By bank	xxx
		By discount allowed	xxx
		By PL a/c (dad debt)	xxx
		By cash (advance)	xxx
		By closing balance	xxx
	xxx		xxx

While examining the sales ledger, the auditor should consider the following.

Opening balance

The opening balance of sales ledger should be verified with the balance shown in the previous year's audited balance sheet.

Transfer entries

There may be transfer entries from one ledger to another ledger account. The auditor should ensure that such transfers are duly authorised by the responsible officer.

Writing off as bad debt

Before writing of any balance as bad debt,the client should take all efforts to recover the amount or amount should have become time barred. Only the top management can decide to give up the claim and the exact amount to be written off. So, the amounts that are written off as bad debts should be subjected to a scrutiny.

Dispute with customers

If an amount due from the customer is in dispute, the auditor should verify the nature of dispute and amount involved. Adequate provision should be made for the amount considered as non-recoverable.

Confirmation of balance

Obtaining confirmation of balances directly from the debtors is the best audit practice. Any fraud committed or misappropriation of amount collected would come to limelight.

Discount allowed

Cash discount is to be allowed only for prompt payments. If the discount allowed is unreasonable or if the allowance is adjusted against the amount that is outstanding, the same should be scrutinised. It could be a fictitious allowance created by a fraudulent employee who had misappropriated the amount collected from the customers.

Part payment by customers

If the customer makes part payments, then the longest outstanding amount is to be adjusted first.

List of balances

The list of closing balance of debtors should be checked with the sales ledger. After a thorough scrutiny, steps should be taken to ensure that adequate and proper provision has been made for doubtful debts.

The casts and carry forwards of sales ledger should be verified.

Disclosure requirements

Any amount due from directors, managers or concerns in which they are interested should be listed out separately.

3) General Ledger

The cash book, purchase book, sales book, sales returns book, purchase returns book are totalled periodically and the summary is posted in the general ledger. The balance in the total account must be equal to the total summary of the respective ledgers.

The auditor should scrutinise the general ledger after verifying the subsidiary books like cash book, sales book, purchases book etc.,

He should also ensure that standard accounting practices are followed.

As per disclosure requirements, any change in the profit of the year under audit must be disclosed in financial statements.

4) Main Journal

The transactions of extraordinary nature for which there are no special books of original entry are recorded in journal. A thorough verification of each journal entry is necessary. It is because a crafty entry may entirely change the picture of financial position of the organisation.

The supporting evidence for the journal entry will be the minutes of the directors meeting, shareholders meeting, copies of the correspondence etc. Generally, these documents are internally generated. So, confirmation should be obtained from outside sources wherever possible.

Transactions that are usually passed through the journal include opening entries, closing entries, adjustment entries, transfer entries, rectification entries and entries relating to share capital.

(i) **Opening entries:** Opening entries are to be verified with reference to the relevant items found on the balance sheet. For the business purchased from the vendor, relevant entries are passed in the journal. This should be verified with agreement between the client and vendor, articles of association and directors' minutes to ensure that there is no manipulation of accounts.

(ii) **Closing entries:** Closing entries are passed for closing and transferring balances from nominal account to profit and loss account. The auditor should verify whether the balances have been properly carried to accounts.

(iii) **Adjustment entries:** The auditor should examine whether all adjusting entries in respect of expenses relating to the period under audit income received in advance and income earned and not received are duly made. He should also scrutinise adjustments in respect of prepaid expenses.

(iv) **Transfer entries:** Proper authorisation should be obtained for the transfer from one ledger account to another ledger account. The auditor should ensure that direct transfer from one account to another is not made.

(v) **Entries relating to share capital:** Entries for issue of shares, allotment and forfeiture of shares etc., are also passed through the journal.

Vouching of Impersonal Ledger

Ledger accounts maintained by any business entity may broadly be classified into two: *Personal* and *impersonal*. Impersonal ledger is called *general ledger* and it can further be divided into two: *real accounts* and *nominal accounts*.

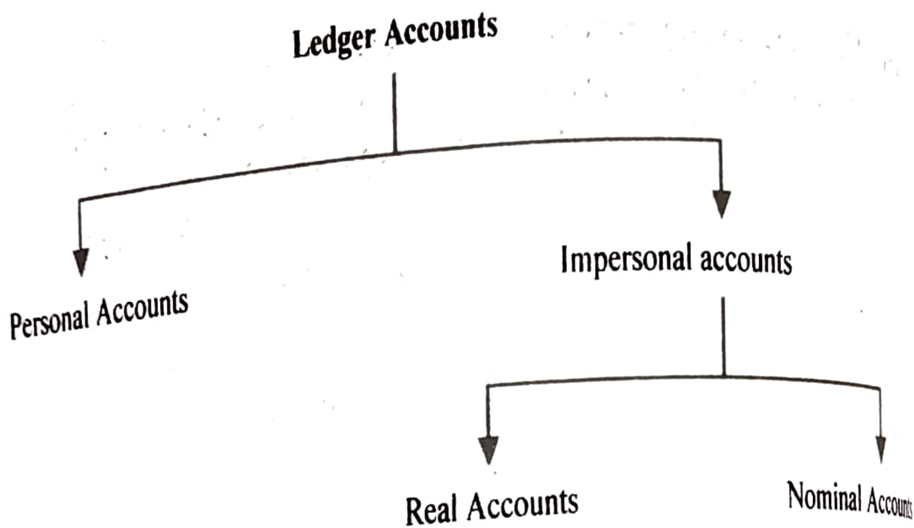

Figure 9.1 - Classification of ledger accounts

Personal Accounts

Accounts which relate to persons are known as personal accounts. They record financial transactions with persons such as various debtors, creditors or suppliers. The capital account of the proprietor is also personal but it is subject to adjustments on account of profit and loss.

Impersonal Accounts

Accounts which are not personal can be of impersonal accounts. Land and building account, wages account, salaries account, rent account are impersonal. Being known as general ledger, it is further grouped into real accounts and nominal accounts.

(a) Real accounts

Real accounts record assets. Real accounts relate to the assets of the firm. For example, accounts relating to land, building, machinery, investments, cash in hand, fixed deposits etc., Balances of real accounts are shown in the balance sheet.

(b) Nominal accounts

Nominal accounts relate to expenses, losses, gains and revenue. For example, salary account, interest account, commission received account etc.,

Nominal accounts pertain to the trading and profit and loss accounts. The net result of nominal accounts is transferred to the capital account.

General Considerations While Vouching Impersonal Ledger

While vouching impersonal ledger, the following points should be considered.

(i) The journal should be carefully vouched to ensure that each entry is supported by sufficient evidence.

(ii) The posting of cash transaction to the impersonal ledger should be thoroughly examined.

(iii) The impersonal ledger consists of records based on entries made in the books of original or prime entry. So the auditor should verify the casts and sub-casts of the various books of prime entry.

(iv) Postings of cash payments and receipts (in respect of nominal accounts) from the cash book to the impersonal ledger should be checked.

(v) The auditor should check very carefully the adjustments which are usually passed at the end of the year when final accounts are prepared. Such adjustment entries may relate to outstanding assets and liabilities or depreciation.

(vi) He should ensure that no capital expenditure is treated as revenue expenditure. All revenue expenditures should be duly shown in the profit and loss account.

(vii) The total of the subsidiary book should be verified.

(viii) The balances in the impersonal ledger should be checked with the trial balance.

I. OUTSTANDING ASSETS AND LIABILITIES

To ascertain the profits of a business entity correctly the following procedures should be adhered to.

(i) All the expenses incurred which relate to the period must be debited to profit and loss account.

(ii) Expenses which have become due but have remained unpaid and which relate to the period should be debited to profit and loss account and shown as an outstanding liability in the balance sheet.

(iii) All the incomes received which relate to the period must be credited to profit and loss account.

(iv) Incomes which have accrued but not yet received should be credited to the profit and loss account and shown as an outstanding asset in the balance sheet.

9.3

Outstanding Assets

Outstanding assets refer to an expenditure incurred in the current year but a portion pertains to the next period. Examples include.

1) Prepaid expenses such as insurance premium paid in advance, tax paid in advance, rent paid in advance etc.,

2) Accrued incomes such as interest due but not received, dividend due but not received and

3) Deferred revenue expenditure.

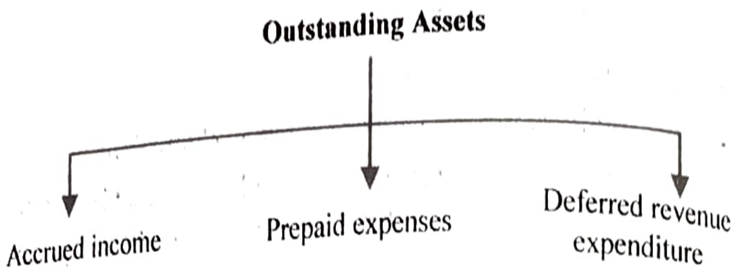

Figure 9.2 - Kinds of outstanding assets

1) Accrued Incomes or Incomes Receivable

Incomes receivable means incomes have become due but have not actually been received in the current year. In concise, all those incomes which are yet to be received are known as accrued incomes. Examples are rent receivable, interest receivable and dividend receivable. In order to arrive at the correct profit or loss, accrued incomes must be accounted for in the profit and loss account.

The auditor must make sure that all such incomes would be duly received. The auditor should check the adjusting entries passed for this purpose on the date of balance sheet.

2) Prepaid Expenses

Prepaid expenses pertain to the forthcoming financial year but have been paid in the current year. Certain expenses are paid in current year but a part of it may relate to subsequent year and which is not covered by the period under audit.

In the words of Arnold W. Johnson", prepaid expenses are unconsumed services receivable or inventories of expense commodities, which will convert into expense as the expenditure is consumed. They are expected to be used up as costs of the revenues of future income periods".

Expenses such as insurance premium, rent, rates, telephone charges, taxes, royalty, subscriptions, advertising etc., may be paid in advance. For vouching

the prepaid expenses, the auditor should examine the nominal accounts, the demand notes, relevant receipt etc. He should make sure that the adjustments have been made in the books of accounts on the date of balance sheet. The calculations in respect of prepaid expenses must be correct.

3) Deferred Revenue Expenditure

Deferred revenue expenditure is non-recurring in nature and its benefits extend for few years. Examples of deferred revenue expenditure are:

- Preliminary expenses
- Special advertisement campaign
- Discount allowed on issue of shares, debentures etc.,
- Expenditure on certain experiments
- Expenditure on acquisition of technical know-how and patent rights etc.,

Such expenses are debited to profit and loss account in instalments over the years. Unwritten portion of deferred revenue expenditure appears on the asset side of the balance sheet.

While vouching deferred revenue expenditure, the auditor should ensure that the computation of the amount carried forward is accurate and the amount charged to the profit and loss account is reasonable. He should also verify the basis on which the exact proportion to be written of is calculated. No capital expenditure or abnormal loss should be treated as deferred revenue expenditure.

Outstanding Liabilities

Expenses which are taken into account for the year under audit but settled only in the subsequent years are treated as outstanding liabilities. They are shown on the liability side of the balance sheet under the head outstanding liabilities.

Outstanding liabilities include unearned income, unpaid expenses and purchases made at the close of the year.

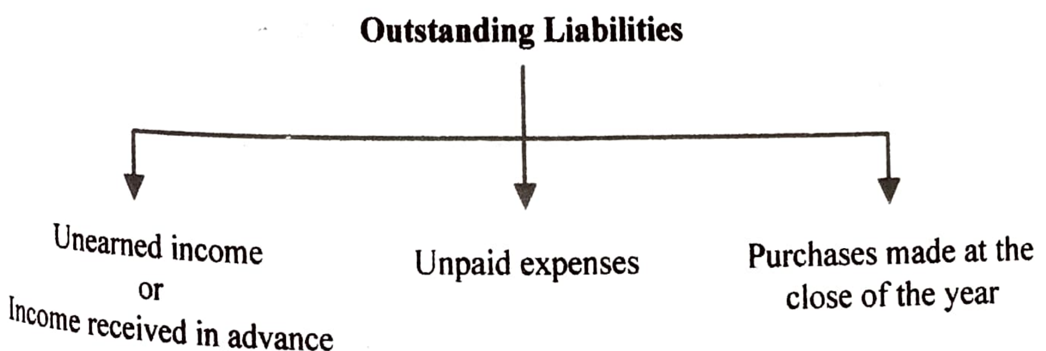

Figure 9.3 - Outstanding liabilities

1. Unearned Income

It is also known as income received in advance. Unearned income refers to the income received in the current year by way of advance but pertains to the subsequent year. A part of income received in the current year relates to future year. For example, rent received in advance. Only that part of income which relates to the current year should be credited to current year's profit and loss account.

The auditor should verify the vouchers and ascertain the amount which is to be credited to the profit and loss account of the current year. The amount which relates to the future years should be treated as unearned income and shown in the balance sheet on liability side.

2. Unpaid Expenses

Expenses have become due for payment but the same has not actually been paid. Such unpaid expenses though not paid relate to the current year under audit. They should be charged to profit and loss account and should also be shown as a liability in the balance sheet. Examples of this kind include outstanding rent, rates and taxes, outstanding wages and salaries, outstanding audit fee, outstanding freight and carriage, outstanding traveller's and agent's commission etc.

To vouch the outstanding expenses, auditor should carefully examine all nominal accounts (like wages, salaries, rent, rates, taxes, interest, discount etc.,), relevant receipts, demand notes and invoices. He should also verify that these have been debited to current year's profit and loss account and shown as liability in the balance sheet.

3. Purchases at the Close

Generally, purchases made at the end of the year are recorded in the stock register but no entry is made in the purchases book. As a result, purchases are understated and profits get inflated. The auditor should ensure that the purchase account is debited with the total purchases made during the year and the unpaid amount is shown as a liability in the balance sheet. The auditor should compare stock register with purchase book at the end of the current year in order to detect unrecorded purchases.

II CONTINGENT LIABILITIES

A contingent liability is not an actual liability. But it will become a liability on the happening of an event in future. In the words of W. B. Meigs a contingent liability is a "potential obligation, which may in future develop into actual liabilities or may dissolve without necessitating any outlay".

A contingent liability is different from absolute liability. An absolute liability is sure to arise but a contingent liability may or may not arise.

A contingent liability can be of two types. It may either involve a loss or it may result in the acquisition of an asset of a corresponding value.

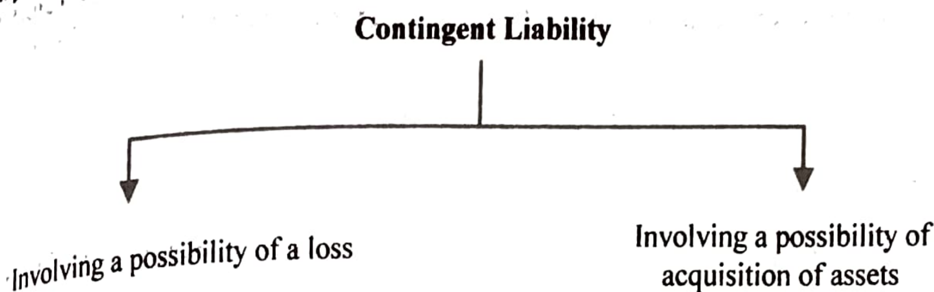

Figure 9.4 - Types of contingent liability

Contingent liabilities involving a possible loss may be of

- Bills receivable discounted or endorsed
- Guarantee or surety given for another
- Damages in case of an action pending in a court of law
- Forward contracts
- Speculative transactions at the commodity or stock exchange
- Additional tax liability, imposition of interest, penalty, etc.

Examples of contingent liability involving a possible acquisition of assets are:

- Purchases of partly paid shares where remaining amount is liable to be paid in case of a call.
- Damages that may arise for any breach of trade agreements
- Service contracts

Auditor's Duty in Vouching Contingent Liabilities

(a) The auditor should ensure that all contingent liabilities are taken into account and exhibited in the balance sheet as footnotes.

(b) He should study the probability of the accrual of each contingent liability.

(c) Necessary provisions should have been made for contingent liabilities.

(d) The minutes of the board meeting will be examined as these will help in determining the contingent liabilities.

(e) Various contracts such as forward delivery contracts and related documents should be thoroughly examined.

(f) Lawers, tax consultants or tax advocates should be consulted on matters such as pending legal cases or tax assessments.

(g) Bank's confirmation should be obtained on bills discounted or endorsed.

The auditor should bifurcate contingent liabilities into two parts (as per part I of Schedule VI of the Companies Act).

(i) The liabilities in respect of which a provision has been made in the balance sheet : These are the liabilities which are to arise, though the amount of such liabilities is uncertain. These should be shown under the head "Current Liabilities and Provision".

(ii) The liabilities in respect of which no provision has been made : These liabilities are likely to arise in exceptional circumstances only or they may not arise at all. These should be shown by way of footnotes to the balance sheet.

The auditor should ensure that relevant provisions have been complied with in recording contingent liabilities.

III CONTINGENT ASSETS

Those assets which may arise on the happening of an uncertain event are known as contingent assets. They are not shown by way of footnotes to the asset side of the balance sheet. Examples of contingent assets would include.

- Uncalled share capital of a company
- Claim on the bills discounted by the client with the bank and the same is dishonoured.
- Legal action for infringement of a copyright.
- Claim for the refund of sales tax, octroi duty etc.

The provisions of the Companies Act do not require the disclosure of contingent assets in the balance sheet.

IV Capital and Revenue Expenditure

Expenditures may be of capital or revenue. A capital expenditure is shown in the balance sheet while a revenue expenditure is charged to profit and loss account. An incorrect allocation of expenditures would distort the profit or position.

Capital expenditure

Capital expenditure results in acquisition of assets of a permanent nature. Such assets are used for the purpose of earning revenue. They are not meant for re-sale. Any expenditure incurred to increase the earning capacity of an existing asset is also capital. The following expenditures are charged to capital expenditure.

- Cost of acquisition of a fixed asset.
- Installation expenses of machinery, equipment etc.
- Additions to and extension of existing assets
- Cost of structural improvements in case of existing assets with an intent to increase the earning capacity of such assets.

- Expenditure incurred to lower production cost or administration, selling and distribution expenses.
- Development expenditure incurred.

A proper allocation of expenditure between capital and revenue is a must in auditing.

Revenue expenditure

Any expenditure incurred in the conduct and running of the business is known as revenue expenditure. Repairs, and renewal expenses fall under this category. Incurrence of revenue expenses does not increase the earning capacity of the business but maintains it. Examples of revenue expenditure would include

- Rent, wages, postage, salaries, interest travelling expenses, advertisement etc., incurred in the day to day routine and running of the business.
- Repairs, renewals, replacement of parts of machine etc., in maintaining fixed assets in proper working conditions.
- Cost of materials, stores bought for consumption or resale
- Freight, cartage, coolie, salesman's commission, advertisement.
- Expenses incurred for covering risks.
- Loss on sale of fixed assets
- Depreciation charged on depreciable assets.
- Annual lease rents.
- Royalties paid.
- Interest on borrowings.
- Accidental losses such as loss on account of fire etc.

Multiple Choice Questions

I. Choose the Best Answer from amongst the following:

1. Which among the following does not fall under outstanding assets?
   (a) Accrued income (b) Prepaid expenses
   (c) Deferred revenue expenditure (d) Unpaid expenses
2. Which among the following does not fall under outstanding liabilities?
   (a) Unearned income (b) Purchases at the close of the year
   (c) Unpaid expenses (d) Accrued income
3. Which among the following is not an example of deferred revenue expenditure?
   (a) Expenditure on certain experiments
   (b) Preliminary expenses

Verification and Valuation of Assets and Liabilities-I

The Primary objective of an audit is the expression of independent opinion as to the truth and fairness of financial statements. Before forming such an opinion, an auditor has to satisfy himself about the title, existence and valuation of assets and the correctness of liabilities shown in the balance sheet. In this regard, verification and valuation of assets and liabilities is an important process undertaken by the auditor.

I Meaning and Definition of Verification

To verify means to ascertain whether the actual facts are in conformity with those reported or asserted. The term *verification* refers to confirmation or proving the truth. In fact, it is the process through which an auditor substantiates his opinion as to the truth and fairness of the financial information examined by him by means of physical examination of items shown in the balance sheet.

In the words of Spicer and Pegler "verification of assets implies an enquiry into value, ownership and title, existence and possession and the presence of any charge on the assets".

To quote Lancaster "the verification of assets is a process by which the auditor substantiates the accuracy of the righthand side of the balance sheet and must be considered as having three distinctive objects,

(a) The verification of existence of assets

(b) The valuation of assets and

(c) The authority of their acquisition".

The term verification is broader and includes valuation of assets and liabilities also.

II Objectives of Verification

The objectives of verification are given below.

(i) To ensure the existence of actual items of assets and liabilities as appearing in the balance sheet.

(ii) To examine the title, ownership and possession of assets.

(iii) To establish proper classification of assets.

(iv) To facilitate valuation of assets and liabilities.

(v) To substantiate the opinion as to the truth and fairness of financial statements.

(vi) To verify whether the assets are free from charge or not.

III Differences between Verification and Vouching:

Vouching is different from verification in some respects.

Points of difference	*Vouching*	*Verification*
1. Nature	Vouching is checking the transactions with documentary evidence in support there of.	It is the physical examination of items stated in the balance sheet.
2. Process	Vouching is followed by verification. Vouching is intended to substantiate an accounting entry.	Verification substantiates expert opinion and assertions made during vouching.
3. Object	Vouching is to examine the adequacy, reliability and authenticity of the transactions recorded in the books with documentary evidence.	Verification enables the auditor to satisfy himself as regards the existence, ownership and possession of items appearing in the balance sheet through their physical verification.
4. Valuation	Vouching is not primarily concerned with valuation.	Verification includes valuation.
5. Scope	Vouching is very wide in its approach. It means judging the correctness of all the entries passed in the books of account.	Verification is confined to confirmation of items of balance sheet through physical examination.
6. Significant	Vouching is the essence of auditing.	Verification in its true sense is an integral part of balance sheet audit.

IV Process of Verification

Verification of assets signifies proving the truth or confirmation of assets as on the date of balance sheet. As a process of physical examination, verification involves an enquiry into

(i) The existence of an asset or liability

(ii) Valuation of the assets

(iii) Ownership and title of the assets

(iv) Correctness of information disclosed

(v) Charge on the assets.

The above points are discussed in considerable detail.

Existence

To confirm the physical existence of an item shown in the balance sheet, an auditor uses two techniques. Actual count or measurement and making a reference to document in support of the item.

The auditor gives an emphasis on physical verification of the item by actual count or measurement. Then the measurement is followed by ascertaining physical existence of assets. It is by making a reference to documentary evidences duly signed by a responsible person of the company. This would enable the auditor to acquire satisfaction as to the physical existence of the item stated in the balance sheet.

For example, cash in hand must be counted by the auditor. In *London Oil Storage Co. Ltd.* Vs. *Seear Hashluck and Co.* (1904), it was held that the auditor should initiate proper steps to verify the existence of assets stated in the balance sheet.

Valuation

The auditor cannot be a valuer *(Re Kingston Cotton Mills Co. Ltd)*. But he should check the valuation of assets with reference to any evidence, which may be available. In doing so, he is entitled to rely on the information provided to him by technical persons. The auditor should ensure that the assets have been valued on the basis of generally accepted accounting principles. The basis of valuation is largely dependent on the nature of business and the objects for which these assets are held. So, different bases of valuation of fixed and current assets are in vogue.

Ownership and Title

An auditor should pay attention to the verification of the ownership of assets and liabilities. If a certain value is attached to an asset which is stated in the balance sheet, the auditor should ensure that the ownership in respect of that asset is vested in his client. Depending upon the nature of an asset or liability being verified, the techniques are employed. For example, to verify the ownership of the investments the auditor may see the name of the client on the share certificates or see a confirmatory certification directly obtained from the banker, mentioning that the securities are held by the banker on behalf of the client. Likewise, a bank balance in the name of the client may be verified with bank confirmation directly obtained from the client's bank. Amount owed to creditors are to be confirmed with the help of confirmation obtained from those creditors.

Disclosure

It is the duty of the auditor to verify whether the information which is required by law, has been given in the balance sheet or not. Satisfaction on this point is very important on the part of the auditor.

Charges

An absolute ownership of an asset vests a clean title in the name of the client. The auditor should examine whether the ownership vested in the client is absolute or it is suffering from a charge like mortgage, hypothecation, pledge, lien, pawn or assignment. The nature of charges created on the assets of the company is discussed below.

Fixed charge

A fixed charge is created on a definite property. It prevents the borrower from dealing with that property without the consent of the holder of the charge.

Floating charge

It is a charge on a class of present and future assets. So, in a sense, it is a charge on changing property. The class of assets is changing from time to time until some steps are taken to enforce the charge. The company will continue to deal with assets charged in the ordinary course of its business.

Pledge

It is a bailment of goods as security till the payment of a debt. The creditor is given the possession of the charged asset. Pledge is exercised with respect to a movable property. On the default of the borrower, the lender can auction the property pledged by serving a reasonable notice on the former.

Mortgage

All the real estate loans require the mortgage of property. The mortgager retains the possession of the immovable property, till the repayment of the loan. There is transfer of interest in the immovable property.

Hypothecation

It is a charge on any movable property existing or future. The charge is created in favour of a secured creditor as a security for financial assistance without delivery of possession of property to the creditor. The borrower retains ownership of collateral but it is hypothetically controlled by the creditor. The creditor has the right to seize possession if the borrower defaults. However, the borrower has the right to sell the asset in the normal course of business. Examples include a bank overdraft (OD) on hypothecation of stock, a vehicle loan in which the financed vehicle itself is hypothecated by the borrower.

Duty of an auditor

The duty of an auditor in respect of charges is two-fold. First, the auditor should ascertain whether an asset of the company is suffering from a charge or not. The second aspect is that if any charge is there on the assets, the nature of such charge must be indicated in the balance sheet.

The following steps would enable an auditor to know whether an asset is suffering from a charge or not.

(i) He must obtain a certificate from the management to the effect that the assets stated in the balance sheet are free from any such encumbrances.

(ii) For any loan obtained, the nature of charge established against the fixed or current assets of the company should be enquired into. The auditor must obtain details about the nature of charge from the lending bank.

(iii) If securities are with the banker. the auditor must enquire whether the securities held are for safe custody or as a cover against credit facilities availed by the client.

(iv) The auditor should directly obtain from the banker, information regarding investments, bill of exchange or other documents of title. He should ascertain the purpose of holding whether it is for safe custody or a security against loan granted by the bank.

Information about loans, overdrafts, cash credits along with limit authorised and the nature of charge, should be obtained from the bank.

(v) If the management does not agree to mention the nature of charge in the balance sheet, he must qualify his report.

VI. Valuation of Assets

Valuation means critical examination and testing of monetary or financial worth of an asset on the basis of some accepted accounting principle. With proper valuation of assets, balance sheet will reveal a true and fair view of financial position of the business and profit computed would be deemed to be accurate. Any error in the valuation of assets will render the financial information incorrect. Therefore, the auditor should pay utmost attention to the process of valuation of assets.

Basis of Valuation

The auditor should keep in view different bases of valuation at the time of valuation of assets. These include cost price, market value, cost of replacement, break up or scrap value and book value.

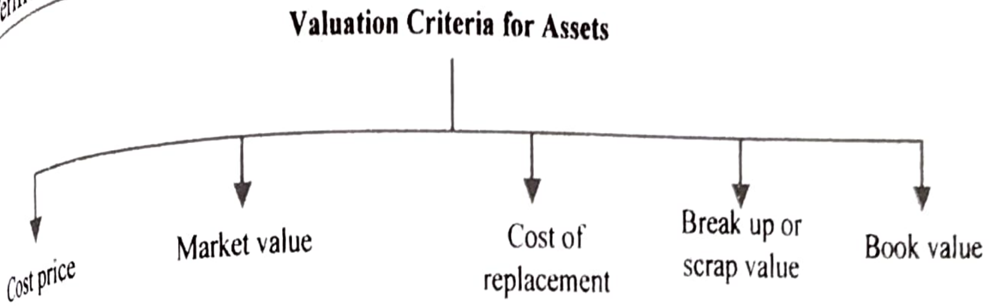

Figure 10.1 - Basis of valuation

Cost price

Cost price is the price at which the asset was originally purchased. It also includes all other charges incidental to put the asset into operation as freight, cost of material and labour used in installation, registration fees etc.,

The Institute of Chartered Accountants of India through its AS 10, "Accounting for Fixed Assets" guides computation of cost price. Accordingly, the cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies, and any directly attributable cost to bring the asset to its working condition for its intended use. Any trade discounts or rebates are to be deducted in arriving at the purchase price.

Examples of directly attributable cost include site preparation cost, initial delivery and handling costs, installation cost such as special foundation for plants, professional fees like fees for architects and engineers.

Market value

Market value or market price is net realisable value. It is the price at which an asset may be sold.

Cost of replacement

It is the price at which a particular asset can be replaced. Cost of replacement represents the price required to be paid to purchase an asset similar to the existing one.

Break up value or scrap value

The value of an asset after its working life is scrap value. It is the price realisable if the asset is old as scrap when it becomes unserviceable. In other words, it is the price expected to be realised after the completion of working life of the asset.

Book value

Book value is the value of an asset as shown in the books of account. It is cost less depreciation charged up-to-date. In other words, it is the depreciated value of an asset.

10.7 Classification of Assets and the its Methods of Valuation

Assets can be divided into five categories namely fixed assets, current assets, intangible assets, wasting assets and fictitious assets.

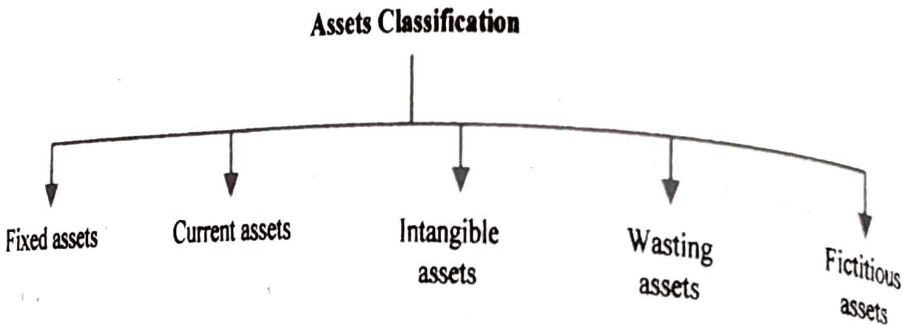

Figure 10.2 – Classification of Assets

Principles of valuation for different types of assets are discussed briefly.

Fixed assets

Fixed assets are in the permanent use of an undertaking for the purpose earning profits.

According to AS 10, Accounting for Assets, it is an asset held with an intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business. Fixed assets may further be classified as depreciable assets, non-depreciable assets and depleting assets.

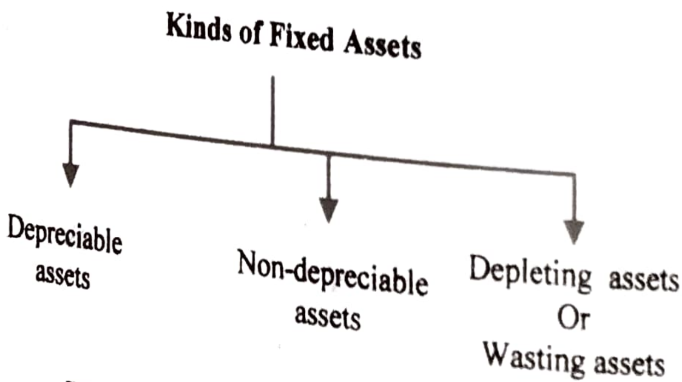

Figure 10.3 – Various Kinds of Fixed Assets

Depreciable assets include building, plant, machinery, furniture, loose tools etc., These assets diminish in their value over a period of time on account of passage of time, repeated use, obsolescence etc.

The prominent asset which is not subject to depreciation or depletion is land.

Assets such as mines, oil wells etc., are depleted assets or wasting assets.

Valuation

Fixed assets are valued according to their nature.

(i) Depreciable assets are valued at cost less depreciation. The depreciated value is taken. The cost of purchase includes all incidental payments necessary to bring the asset to working condition.

(ii) Non-depreciable fixed assets like land are valued at cost price. The cost price includes the original cost of acquisition, *i.e.*, purchase price, commission paid to brokers, registration fees, legal expenses and expenses incurred by way of levelling, cleaning etc.,

(iii) In the valuation of fixed assets, the factors to be considered are

- Original cost of the assets
- Expected life of the assets
- Wear and tear of the assets
- Scrap value realisable at the end of working life of the assets
- The method of depreciation adopted
- The replacement value of the assets
- Obsolescence *i.e.*, the chances of the assets becoming out of fashion

(iv) The depreciation on fixed assets should be distributed over the useful working life of the asset. As a result, the profit and loss account of the each accounting years bears the proportionate amount of loss caused on account of depreciation.

Current assets

Current assets are differently referred to as floating, circulating or liquid assets. Current assets are meant for resale. They cannot be put to constant use. They are most likely to be converted into cash in the short run, *i.e.*, within twelve months in the ordinary course of business. Current assets strengthen the liquidity position of the entity. Stock in trade, sundry debtors, prepaid expenses, bills receivable, bank balance, cash in hand etc., are treated as current assets in the business.

Normally current assets are valued at book value. They are to be disclosed in the balance sheet at cost or market price whichever is less.

Cost = Purchase price		xx
Add : Duties		x
Taxes		x
Freight inwards		x
Direct expenses if any		x
		xxxx

Less:	Trade discount	X	
	Rebates	X	
	Duty drawbacks	X	
	Subsidy	X	
			X
	Cost		XX

The closing stock of goods is valued on the date of balance sheet either at cost price or market price whichever is lower. In case of book debts, a provision is made for bad and doubtful debts. Raw materials and semi-finished goods are valued at cost.

In short, the guiding principle "cost price or market price whichever is less" is followed for the valuation of floating assets.

Intangible assets

Intangible assets do not have their form or physical existence. By virtue of their utility in the business, intangible assets appear in the balance sheet. Important intangible assets include goodwill, patents, copyrights, trademarks, etc.

Intangible assets should be valued on the following lines.

(i) Intangible assets are to be written off over a reasonable period. Proportionate amount should be debited to profit and loss account on account of writing off of intangible assets.

(ii) Until they are written off fully, the assets should be carried forward in the balance sheet at their actual value.

So, the valuation of intangible assets is more or less similar to that of fixed assets.

Wasting assets

Wasting assets are of a fixed nature but consumed gradually. Mines, quarries are referred to as wasting assets. These assets are exhausted in the process of earning profit. Wasting assets are different from fixed assets. First, a fixed asset is replaceable while a wasting asset once used up is irreplaceable. Second, fixed assets decrease in their value due to normal wear and tear. But the value of a depleting asset declines as a result of gradual exhaustion.

Any one of the following methods of valuation may be adopted for wasting assets depending upon the situation.

(i) On the basis of expected physical exhaustion during the year

$$\frac{\text{Cost of mine}}{\text{Expected output during the normal life}} \times \text{Output during the year}$$

(ii) In case of a mine taken on a lease basis, the lease amount may be written off over the period of lease.

Fictitious assets

Fictitious assets do not have any physical existence. They are not realisable. Examples of fictitious assets include preliminary expenses incurred, development expenses, debenture discount, discount on issue of shares, amount spent on special advertisement campaign. These items involve expenses without any exchange value.

From valuation point of view, fictitious assets are treated as deferred revenue expenditure. In this sense, though it is incurred in one year, its benefits accrue over a fairly long period. It is temporary capitalisation of revenue expenditure with the ultimate object of spreading the amount over several future years. It is amortised over a period.

Fictitious assets are shown in the balance sheet as the amount of expenditure less amount written off against the profit and loss account up-to-date.

Auditor's Duty or Position of Auditor in respect of Valuation of Assets

An auditor is not a valuer and cannot be expected to act as such. He can depend on an expert's valuation in this regard. His duty is to test the valuation to ensure that the current values are fair and reasonable and are in accordance with the accepted commercial principles.

As observed in *Re Kingston Cotton Mills Co. Ltd.*, "He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations provided that he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful. The duties of auditors must not be rendered too onerous. Their work is responsible and laborious, and the remuneration moderate. Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company and are undetected for years by directors. So as to hold would make the position of an auditor intolerable."

It is understood from the above that an auditor cannot be expected to be a technical expert. So he is justified to believe in technical experts as far as valuation of assets is concerned.

At the same time, the auditor cannot escape his liability if the valuation by the officials of the client proves to be incorrect. He would be very cautions while examining the valuation of assets.

At the time of valuation of assets, an auditor must ensure that:

(i) Commonly accepted accounting principles have been followed in the valuation process.

(ii) Steps taken in the valuation of assets are in tune with established practices prevailing in the client's company.

(iii) Auditing considerations have been taken into account at the time of valuation of assets. It is quite satisfactory from the stand point of professional bodies.

(iv) Valuation of assets conforms to the business conditions.

It may be concluded that mere verification of the physical existence and ownership of assets does absolve the auditor of his responsibilities. He should also ensure that the assets stated in the balance sheet are correctly valued. He should see that the basis of valuation is correct and the valuation is in accordance with the generally accepted conventions and accounting principles. Reliable and adequate provisions should have been made for all contingencies.

Verification and Valuation of Specific Fixed Assets

Verification of assets is an important segment of auditing and valuation of assets is its integral part. It is a combined consideration for examining the position of different assets shown in the balance sheet. Every business employs a variety of assets to manage its affairs. The size and variety of assets will depend upon the nature and size of the business entity. Fixed assets like goodwill, freehold property, leasehold property, plant and machinery, furniture and fixtures, patents, trade marks and designs, copy rights, vehicles and assets acquired under hire purchase agreement are considered for their verification and valuation.

Goodwill

Goodwill is an intangible asset. Though it is intangible, it is not fictitious. It represents the earning capacity of the business.

Goodwill does not appear in the balance sheet except when it is actually purchased, whole assets are revalued or in the case of a partnership firm it is brought into books in case of change in partnership deed.

Since goodwill is intangible, its physical verification is impossible. However, goodwill will be verified and valued in the following ways.

(i) Ensure that the company is justified in creating goodwill in its books of account.

(ii) Verify the amount of goodwill in case of purchase of business with purchase agreement with the vendor which shows the price paid for it.

(iii) Ascertain that the sum paid for goodwill does not exceed the difference between the total purchase consideration and the value of net tangible assets acquired.

(iv) It is a prudent financial policy to write off the value of goodwill out of the profits. Where it is written off, the auditor should examine the board's resolution. It was held in, *Stapley vs. Read Bros Ltd.* (1924) that profits so applied were not irrevocably allocated and might have been brought back later to the credit of profit and loss account and used for dividend purposes if goodwill had in fact maintained its value.

Freehold Property

A freehold land is any land held by the organisation with absolute right. It is immobile and indeterminate in duration. The auditor should consider the following points for verification and valuation of freehold property.

(i) To verify the cost of land, the auditor may verify the original title deeds indicating the name of the client as the owner. The original title deeds may not be available with the client for two reasons. (a) The title deeds are with the solicitor or banker for safe custody. (b) If the land is mortgaged, the title deed will be in possession of the mortgagee. In these circumstances, the auditor should obtain a certificate to this effect from the person who is in the possession of the document.

(ii) The area covered by the freehold land must be noted.

(iii) If the land is purchased during the year, the registration charges, legal expenses and other expenses incurred exclusively for the acquisition should be duly capitalised to arrive at the cost of acquisition of land.

(iv) The auditor may vouch the sale or purchase of land with reference to the receipts, bank records, correspondence etc.

(v) The auditor should ensure that proper depreciation has been provided for the property.

(vi) Depreciation should be charged on freehold building only, but not on freehold land.

(vii) The auditor should verify the basis of valuation. He must see that it is valued at cost less depreciation, if applicable.

(viii) The auditor should confirm that the land is used only for the purpose of the business and if it is leased out, the lease agreement should be vouched.

Leasehold Property

If the assets are acquired by the company on lease for a particular period, they will be called leasehold property. Following steps are necessary for the verification and valuation of leasehold property.

(i) The auditor should carefully examine the lease deed noting the date of commencement of lease, area covered, period of expiry, terms of termination, provisions affecting additions, hiring out, ground rent etc.

(ii) The auditor should ensure that the lease deed is duly registered and all the conditions specified in the lease deed are complied with.

(iii) The expenditure incurred on acquisition of the lease should be capitalised and written off uniformly over the lease period. Lease rent paid annually, should be treated as revenue expense and debited to profit and loss account.

(iv) If the property is sub-let, the auditor should verify the agreement entered into with the sub-lessee.

(v) If the leasehold property is of building, tax paid and repair expenses met should be treated as operating expenditure.

(vi) Sufficient depreciation should be provided for in respect of the property.

(vii) Leasehold property should appear in the balance sheet with the required details.

Plant and Machinery

Every manufacturing organisation needs a set of plant and machinery for its production process. A separate plant register is maintained to keep a detailed record of plant and machinery engaged in the production. Following steps are necessary for verification of plant and machinery as an important item of the balance sheet.

(i) Examine the plant register to know about the cost of plant and machinery, provision made for depreciation on plant and machinery, etc.

(ii) Ask for a schedule of various plants possessed by the organisation for making a comparison between the details given in the plant register with the schedule.

(iii) Check the valuation with invoices, import documents, acquisition charges (clearing agent's bills, bills of entry for customs duty and sales tax etc.,

(iv) Verify the physical existence of plant and machinery on random basis by conducting spot inspections.

(v) Examine the machinery purchased during the year with reference to invoice and relevant vouchers.

(vi) See that necessary entries have been passed for the sale of machinery during the year and profit or loss arising out of sale has been duly accounted for.

(vii) See that all repairs to plant and machinery are charged to revenue account and not capitalised.

(viii) Verify that adequate depreciation is calculated on consistent basis.

(ix) Vouch all the documentary evidences in support of additions to and deletions from the account. Also verify authorisation in this respect.

(x) See that on sale of a plant the accumulated depreciation on the plant sold which is included in the depreciation reserve is properly adjusted.

(xi) Verify the approval of Reserve Bank of India, the import licence, bank advice regarding payment made etc., in respect of imported machinery.

(xii) Ensure that plant and machinery is shown in the balance sheet at cost less depreciation.

Furniture and Fixtures

Though furniture is a movable asset yet it is considered a fixed asset. Chairs, tables, racks, almirah etc., are the items of furniture. Fixtures like fans, air conditioners, coolers, fridge, geysers etc., are normally fitted to walls or ground and are immovable property. The following steps will be taken for verification and valuation of furniture and fixtures.

(i) Verify the furniture stock register as to whether it is properly balanced and balance is clearly shown therein.

(ii) Verify the assets acquired during the current accounting period with reference to the purchase invoice.

(iii) Carefully scrutinise the sale of old furniture if any during the year. Profits or losses arising from such sale is to be verified.

(iv) Any expenditure incurred while purchasing furniture should be duly capitalised. Freight and carriage paid on bringing furniture to the factory should be charged to furniture account.

(v) Repairs to furniture are to be charged to profit and loss account.

(vi) Furniture and fittings should be valued at cost less depreciation.

(vii) Depreciation charged on different items of furniture should be reasonable. It should be based on a fair estimate of their working life.

(viii) Old and unserviceable furniture and fixtures should be discarded by a responsible officer with proper record for such items.

Patents

Patent gives an investor exclusive right for years to make, use or sell his invention. Verification and valuation of patents require the following considerations.

(i) Ask for a list showing description of each patent, registration details, assignment deeds, last renewal certificates and number of years to run.

(ii) Verify the certificates issued by the patent office in respect of patents granted.

(iii) Inspect the agreement for the purchase and note the period expired and the remaining life of the patents.

(iv) Verify that all renewal fees have been paid and the amount charged to revenue.

(v) See that the patents, which have expired are written off over their legal life. If the commercial life of the patent is found to be shorter due to obsolescence, patents may be revalued and written off at a higher rate.

(vi) See that proper distinction is maintained while charging the cost of the patent to capital and revenue.

Trade Marks and Designs

"Trade marks are capable of being represented graphically and which are capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging and combination of colours".

(i) Obtain a list of trade marks acquired or developed by the organisation and verify that the renewal fees are paid at the prescribed time.

(ii) Examine the certificates of grant of trade marks to ensure the ownership of trademark.

(iii) See that all costs of registration of trade marks registration fees, payments to artists and salaries and overheads attributable to the time spent incurred in developing designs of trademarks have been capitalised. If the trademark is acquired, the actual cost of acquisition and the direct expenses incurred to register the trademark should be capitalised.

(iv) See that renewal fee has been charged to revenue. Verify the last renewal fee receipt to ensure that the trademark has not been allowed to lapse.

(v) Verify the amount of depreciation provided for. The value of trademark may be amortised over its commercial life. If it becomes obsolete, it may be written off at a higher rate.

Copyrights

Copyrights should be verified as follows.

(i) Verify the agreement under which the copyright has been assigned.

(ii) In case of copyright purchased on royalty basis, see that the amount of royalty paid is debited to the profit and loss account.

(iii) If copyright is obtained for a few years, ensure that its full value should be written off before the expiry of the said period.

(iv) Ensure that the copyright which has become obsolete has not been valued and shown in the balance sheet.

(v) Call for a schedule of copyrights from the client for a careful scrutiny, where copyrights are so many in number.

(vi) Vouch the payments made in lumpsum with the receipts.

(vii) Compare the list of copyrights for the year under audit with that of the previous year. If any copyright is deleted, analyse the reasons for such deletion. The deletion may be either due to sale, surrender or obsolescence.

(viii) Evaluate the mode of revaluation of copyrights for the year.

Vehicles

If motor vehicles in the possession of clients are large in number, a separate register called "motor vehicles register" is maintained. Motor vehicles are shown separately in the balance sheet.

Following steps are necessary for the verification of motor vehicles.

(i) Call for the details of all vehicles such as
- Registration number
- Description of vehicles
- Engine number
- Chassis number
- Cost of the vehicle

(ii) See that vehicles are grouped according to their nature such as bus, car, motor cycle, etc.

(iii) Compare the registration number and description given in the registration book with those given in the "registration book".

(iv) Check the registration book and licences and ensure that the vehicles are registered in the client's name. If it is registered in the name of other person, scrutinise the letter confirming the arrangement and make sure that there is no charge on the vehicle in favour of such person.

(v) Examine the insurance premium receipts to ensure that the vehicles are fully insured against losses on account of accidents, third party, riots, theft etc.

(vi) Check the logbooks to verify the existence and use of vehicles.

(vii) See that vehicles are adequately depreciated on a consistent basis.

(viii) Ensure that maintenance charges and yearly renewal fees are charged to revenue account.

Assets Acquired under Hire - Purchase Agreement

Assets acquired under hire-purchase agreement should be verified as follows:

(i) See that an asset bought under hire purchase agreement is brought on record at its present value (cash price)

(ii) See that the additional amount resulting on account of deferred payment is charged to interest account.

(iii) Ensure that the difference between the payment agreed to be made and present cash price of the first year is treated as interest. The whole of interest should be temporarily debited to interest suspense account. Every year a proportionate amount of interest applicable to that year should be written off to the revenue account in that year.

(iv) See that interest is calculated on the cash price of the asset and not on the total instalment value.

Verification and Valuation of Investment

Investments represent government securities, shares, debentures and immovable properties. Organisations earn interest, dividend, royalties, rent etc., on their investments. The auditor is required to verify the existence of all such investments and ensure that they appear in the balance sheet at a correct value. He should take the following steps in this regard.

(i) Call for a schedule of investments where the number of investments held by the company is large. The schedule will indicate information about the names of securities or investments, date of acquisition, cost of acquisition, rate of income, date of receipt of income, details of tax deducted at source etc.,

(ii) Physically verify the investments. For investments under the custody of the banker or solicitor, obtain a certificate to that effect.

(iii) Compare the schedule of investments obtained with relevant ledger accounts to ascertain any discrepancy.

(iv) Look into the reason for investments being held in the name of the any other person such as trustee, nominee, etc.

(v) Ensure that investments are disclosed in accordance with the recognised accounting policies.

(vi) Make sure that the expenses incurred wholly and exclusively for the purpose of acquisition of the investments are included in the cost of acquisition.

(vii) Vouch the purchases of investments with brokers bought note and see the terms of purchase (ex-dividend or cum dividend). Verify the sales made during the year with the broker's sold note. Also see the board's resolution for the authority of purchase or sale of investments.

(viii) Check the market value with the quotation list on the date of the balance sheet. Loss on account of decline in the market value compared to cost should be provided in the accounts.

(ix) Scrutinise each individual investment account to ensure that all interests have either been received or accrued in books.

(x) See that dividends received on investments have been duly credited in respective ledger accounts.

(xi) Note any amount of uncalled capital relating to shares held as investment. A foot note of it is to be given in the balance sheet.

Verification and Valuation of Current Assets

A discussion follows on verification and valuation of the following current assets.

- Cash in hand
- Cash in transit
- Cash at bank
- Debtors
- Bills receivable
- Loans and advances and
- Inventories

Cash in Hand

Defalcation or embezzlement of cash has become very common. So, the auditor has to be very careful while verifying cash in hand.

(i) Conduct a surprise verification of cash. Such verification enables the auditor to detect the embezzlement, if any.

(ii) Count the cash in hand at one sitting and compare it with the cash book balance.

(iii) If organisations maintain cash at different places (main cash, petty cash, branch cash, stamps etc.,), assemble all the cash at one place and verify them physically.

(iv) If branches are situated outside the town and cash with agents, obtain a certificate from the branch manager or the person in charge of cost and agent confirming the balance.

(v) Where there is a heavy cash balance at the end of the year, ascertain whether keeping of such large balance of cash is really needed.

Generally, discourage the practice of keeping large balance of cash from the view point of internal control.

Cash-in-Transit

The auditor should verify the cash in transit with the help of proper documentary evidence and correspondence. He should see that entries have been made in the books when such money is received.

It is important to consult the guidance note of the Institute of Chartered Accountants of India on cash-in-transit.

"The auditor should carry out cash verification at the year's end or by way of a surprise check any time during the year. Postage and other stamps are often grouped with cash in hand in balance sheet. All funds in the same location should be produced simultaneously. If the cashier has access to funds belonging to other entities, *i.e.*, staff club, associated companies, etc., the auditor should seek cooperation of these entities in ensuring that all funds are checked simultaneously. If I.O.Us are found in balance, the matter must be taken up with the senior officer of the company and explanation obtained".

Cash at Bank

While verifying cash at bank, the auditor should:

(i) Evaluate internal control measures relating to cash and bank balances.

(ii) Compare the balance as shown in the pass book with that shown in the bank column of cash book.

(iii) Prepare bank reconciliation statements in order to detect various types of frauds.

(iv) Get a certificate from the bankers for balance in client's account as on the balance sheet date.

(v) Obtain separate certificates for fixed deposit account, current account, savings bank account etc., from the bank.

(vi) Take note of blocked accounts, if any.

(vii) If the cheques issued become stale, treat them as unpaid.

(viii) Carefully examine the fixed deposits in respect of their date of issue, amount, rate of interest date of maturity etc., and get the interest accrued on deposits during the year duly adjusted.

(ix) See that any depositor balance held under the requirements of any law are disclosed in the financial statements.

Debtors

Book debts represent all claims against third parties including the amount due from customers. But advances and loans are not treated as book debts.

For verification and valuation of book debts, the auditor should:

(i) Obtain a list of debtors duly certified by the responsible official and scrutinise its accuracy.

(ii) Get confirmation letters of the statement of accounts directly from debtors. Verify the same to check the actual existence of debtors.

(iii) Verify whether the debit balance of the sales ledger agrees with the control account or not.

(iv) Conduct test checking of individual accounts, the balance of ledger accounts and some of the entries of control accounts for common items.

(v) See that the book debt balances do not include the amounts due in respect of goods out on sale or return basis.

(vi) Ensure that adequate provision has been made for bad and doubtful debts.

(vii) See that the debtors are classified as per the requirements of the Companies Act, 2013 and shown in the balance sheet, in the same order.

(viii) See that customer's account is duly debited for goods sold on credit.

(ix) Scrutinise disputed balances on account of some claims or complaints.

(x) See that the amount collected from debtors, particularly towards the end of the year, is promptly credited to their accounts.

(xi) Examine thoroughly the system of internal check in operation for book debts.

Bills Receivable

In the process of verification and valuation of bills receivable, the auditor should.

(i) Verify the bills receivable book with bills receivable in hand.

(ii) Call for a certified schedule of bills in hand on the balance sheet date.

(iii) Ensure that the bills are property drawn and duly stamped.

(iv) Verify the bills discounted with the entries made in the cash book.

(v) See that a note of contingent liability in respect of bills discounted is shown in the balance sheet.

(vi) Verify the bills deposited with the bank for safe custody or for security of a loan with the help of a certificate obtained from the bank to that effect.

(vii) See that discount charged on bills maturing after the balance sheet date is shown as an asset under the heading, "rebate on bills discounted not yet due".

(viii) See that the bills which have matured but not have been paid are renewed subsequently.

(ix) Physically verify dishonored bills.

(x) See that adequate provision has been made against possible losses on account of bills likely to be dishonoured.

Loans and Advances

All loans and advances given by the company may fall into three categories:

1. Secured
2. Partly Secured
3. Unsecured

Verification procedures for the secured loans are discussed briefly.

Secured loans against Land and Buildings

These are the loans granted against the security of land and buildings. For verification of secured loans, the auditor should:

(i) Examine the memorandum and articles of the company to see whether it is empowered to grant loan against land and property.

(ii) Inspect the minutes of meeting of board of directors.

(iii) See that the borrowing company has borrowed within its borrowing limits.

(iv) Examine the mortgage deed and see whether it is properly executed in favour of his client or not.

(v) Examine the title deeds relating to the property.

(vi) Examine the certificate from the Registrar of Companies, if the borrower is a limited company.

(vii) Obtain a certificate as to the value of the property from the valuer in order to ascertain the adequacy of margin of security.

(viii) In case of second margin, see that the first mortgagee has been duly informed of the second mortgage.

(ix) Verify the particulars of loan such as amount of loan, rate of interest, date of receiving interest and the period of loan.

(x) See that interest is regularly received on due dates.

(xi) In case of overdue of interest, see that adequate provision has been made for doubtful recovery.

Loans against movable properties

Loans secured against movable properties like goods, insurance policy, shares, debentures etc., should be verified in the following manner.

I. Loan against goods

The auditor should:

(i) Examine godown keeper's receipt which has been given as security.

(ii) If goods were at the dock or in bonded warehouse, verify dock warrant or the warehouse certificate duly endorsed in favour of the client.

(iii) In the absence of dock warrant or warehouse receipts, examine delivery notes duly endorsed in favour of the client.

(iv) See that the borrower has paid the rent for the godown or warehouse. If paid by the client see that the rent is either recovered from the party or debited to the borrower's account.

(v) In case of loans advanced against goods in transit, inspect relevant documents (railway receipt, bill of lading, letter of hypothecation, insurance policy or invoices duly endorsed in favour of the client).

(vi) Verify the market valuation of goods from market quotations, invoices etc., to establish the value of the security.

II. Loan against insurance policy

If loans are given against the security of insurance policy, the auditor should:

(i) Verify the date on which the premium of the policy becomes payable and examine the last receipt for the payment of premium to prevent the policy from lapsing.

(ii) If the premium is paid by the client, see that the amount so paid has been debited to loan account.

(iii) Scrutinise the policy and the notice of assignment to the insurance company.

(iv) ascertain the latest surrender value of the policy by writing to the insurance company and see that loan advanced is within the surrender value.

III. Loan against security of shares

If the loan is granted against the security of company shares, debentures etc., the auditor should:

(i) Obtain a list of stock and shares which have been held as security in order to ensure that they have been transferred in favour of his client.

(ii) Obtain a written confirmation of the loan from the borrower.

(iii) Verify the share certificates with blank transfer deeds duly signed by the borrower.

(iv) Verify that partly paid shares have not been accepted as security for loan.

(v) Enquire whether lien has been got marked by the client in the share register of the company whose shares are held as security.

(vi) Verify that the value of the security sufficiently covers the loan granted.

(vii) If the margin is not adequate, ask the client to demand more security.

Unsecured loans

Unsecured loans are granted against the personal security of the borrower. The auditor should enquire about the financial position of the surety, because the value of the security depends upon his financial position. He should see that any change in terms of the loan is made only with the consent of the surety. Any change made without his permission will discharge him. Promissory note should be verified with reference to the date of maturity.

Stock-In-Trade / Inventories

Inventories or stock-in-trade includes the following.

- Consumable stores and spare parts
- Loose tools
- Raw material
- Work-in-progress
- Finished goods
- Waste and by-products
- Packages and containers.

Verification and valuation of inventories involves three important steps.

1. Examination of stock taking procedure (physical verification)
2. Examination of valuation process.
3. Evaluation of accounting system and internal control over stock.

1. Physical Verification

Stock taking means physical count of stock in trade. In Kingston Cotton Mills Co. Ltd (1896), Lord Justice Lindley observed: it is no part of the auditor's duty to take stock. No one can contend that it is so. He must rely on other people for details of the stock-in-trade. In the case of a cotton mill, he must rely on some skilled person for the material necessary to enable him to enter the stock-in-trade at its proper value in the balance sheet".

Lord Justice also observed, "an auditor is not bound to be a detective, or, as was said to approach his work with a foregone conclusion that there is something wrong. **He is a watch dog but not a bloodhound.** He is justified in believing the tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest to rely upon their representations, provided he takes reasonable care".

In *Re Westminster Road Construction and Engineering Co. Ltd* (1932), it was held that an auditor must make the fullest use of all materials available to him and although he is neither a stock taker and nor a valuer of work-in-progress, he will be guilty of negligence if he fails to take notice of all available evidence from which it could be reasonably deducted that the work-in-progress was overvalued.

The above decisions throw light on the general guidance of the auditor.

(i) It is no part of auditor's duty to take stock.

(ii) He can rely upon the statements and reports made available to him for the valuation of stock.

(iii) An auditor would be failing in his duty if he does not take reasonable care in verifying the statements of stock which are put up to him, according to the information in his possession and the expert knowledge

expected of him in regard to methods of verification and stock control. An auditor should examine client's written instructions for stock taking.

Before carrying out stock taking the value of closing stock is to be arrived at in the following manner.

Opening stock (at the beginning)	xx
Add: Purchases during the year	xx
	xxxx
Less: Sales during the year	xx
Closing stick (at the year end)	xx

The closing stock so arrived at is verified through physical count (stock taking). The auditor should be physically present at the time of stock taking. He should ensure that the method of stock taking is satisfactory.

The auditor should:

(i) Examine the internal check system in operation.

(ii) Apply test checks on the verification done by management.

(iii) Check the stock sheets with the stock registers.

(iv) Test quantities of rough stock sheets with bin cards.

(v) Check quantities shown on bin cards with quantities stated on stock cards.

(vi) Obtain explanation for material differences.

(vii) Test check the accuracy of stock cards with purchase invoices, requisitions, sales invoices etc.,

(viii) Verify additions of permanent stock records.

(ix) Examine goods inwards with permanent stock records around balance sheet date.

(x) Check goods outwards book into permanent stock records around balance sheet date.

(xi) Check stock records with items passed through sales journal around balance sheet date.

(xii) Inspect certificate from third parties for stocks held outside the business.

(xiii) Compare quantities held in different categories with quantities held in previous year and note material differences.

2. Examination of Valuation Process

Stock should be valued at cost or net realisable value whichever is lower on the date of the balance sheet. The following section focuses on the valuation of different components of inventory such as

- Raw material
- Work in progress
- Finished goods
- Stock in transit

I. VALUATION OF RAW MATERIALS

"Anticipate no profits and provide for all possible losses" is the maxim for valuation of raw material. Accordingly, stock of raw material is valued at cost or market price whichever is lower on the date of the balance sheet.

Cost of raw material includes purchase price of raw material, payments towards loading and unloading and storing the material and other directly attributable expenses incurred on account of placing and receiving the order and carriage inward etc.,

Assessing cost price

Methods used for pricing raw materials include FIFO, LIFO, average cost method, base stock price method etc.,

First-In-first-out method (FIFO)

Materials received first are issued first. After exhausting the first lot of material purchased, next lot is taken up for issue. Materials are issued in the order in which they are purchased. Therefore, closing stock of material is valued at the latest purchase price. When prices are falling, the FIFO method is considered inappropriate.

Last-in-first-out method (LIFO)

The material received last is issued first. So, pricing of issues is done in the reverse order of purchases. When prices show a rising trend, this method of pricing inventory of raw material is considered appropriate. The stock is valued at the earliest purchase price.

Average Cost Method

Costing is done at an average price and not at the exact cost price. The simple average is calculated by dividing the total rates at which materials were acquired at different intervals. The underlying assumption is that the identity of different lots of goods is lost when they are received in store.

Base stock price method

A minimum quantity of stock known as *base stock or safety stock* is always held at the original cost. Base stock is not supposed to be issued unless an emergency arises. This is treated as fixed stock. Materials which are in excess of base stock are issued by following either FIFO or LIFO principle.

Whatever basis of valuation of stock is adopted, it must be reasonable and followed consistently from year to year. Whether prices show rising or falling trend, stock of raw material cannot be valued at a price higher than the cost price.

Assessing market price

Market price is viewed from two standpoints: *replacement cost* and *net realisable value.*

Replacement cost

It is the cost of replacing the stock of identical items on the date of the balance sheet. In other words, it is the cost of purchasing similar quantities and same kind of material at the price prevailing in the market.

Net realisable value

It is the estimated price at which the stock of goods can be sold in the market. In other words, it is the price prevailing in the market. It is the price that would be realised if the goods held were sold in the form of finished products or otherwise on the date of the balance sheet.

Whether it is replacement cost or net realisable value which should be considered as the market price is the question now. The Institute of Chartered Accountants of India as well as the Institute of Chartered Accountants of England and Wales have suggested that the *net realisable value* will be representative of the market price.

II. VALUATION OF WORK-IN-PROGRESS

There may be some semi-finished goods in stock on the last day of the accounting year. They are partly finished goods. Work-in-progress is valued at cost price including the cost of raw materials used and the proportionate amount of wages, establishment charges etc.

Auditor's duty

The Companies (Amendment) Act, 1960 requires the work-in-progress to be shown separately in the balance sheet. So, the auditor should carefully examine all the accounts relating to work-in-progress.

(i) The auditor should carry out compliance and substantive test of costing records. Where cost accounts are properly maintained, he should check the statement of raw materials used and wages. If not, he should prepare a detailed statement to know the progress of work completed.

(ii) The auditor should take up a physical check of semi-finished goods.

(iii) He should review the basis for inclusion of overheads. The overhead expenses included in the valuation should not be excessive.

(iv) The auditor should take note of the basis of valuation and ensure that it is consistent with that of the previous year regarding treatment of overheads and other charges.

(v) The progress of work should be verified with reference to the time spent and work being done.

(vi) The auditor should have a review against budgets, contract prices and records of other similar jobs to ensure that it is in order to value the work-in-progress at cost and that no reduction to net realisable value is necessary.

III. VALUATION OF FINISHED GOODS

The cost of finished goods will include materials and labour along with an allocation of overhead costs. The auditor certifies the valuation of finished goods done by the officials of the client. The auditor should:

(i) Verify that the obsolete, slow moving, redundant or damaged stocks are written off down to realisable values.

(ii) Test check extensions.

(iii) Verify addition of stock sheets.

(iv) Prepare summaries of stocks classified according to the nature of the business with comparative figures for preceding year.

(v) Take note of the value of stocks furnished for insurance purpose.

(vi) See whether there is any pledge or lien in connection with stocks.

(vii) Compare values with previous year to see whether there are any significant variations.

(viii) Check valuation with subsequent selling prices.

Valuation of stock-in transit

For valuation of stock intransit the auditor should:

(i) Ensure that the basis of valuation is consistently followed.

(ii) Verify valuation with invoices, bank advices, vouchers etc.

(iii) Ensure that stock has been subsequently received.

(iv) See that adequate provision has been made for any items received as damaged.

(v) See whether the market value of the items in transit shows a material fall as compared to cost.

(vi) Ensure that the liability for stock in transit is reflected in the accounts.

3. Evaluation of Accounting System and Internal Control Over Stock

The auditor should review the following aspects of internal controls over stock-in-trade.

(i) Adequate controls must be in force to safeguard the stock against loss through pilferage, exposure to weather and other hazards. The storage must protect items of inventories against damage, deterioration etc.

(ii) Records of stock movements should be periodically reconciled with accounts and costing records.

(iii) All stock movements should be properly authorised.

(iv) There should be periodical stock taking.

(v) Slow moving stock should be identified and action should be taken to get rid of it.

(vi) Various items of inventories should be adequately insured against fire, theft, etc.

Recognised Accounting Principles Governing Valuation of Inventories

Accounting Standard 2 (AS 2), valuation of inventories issued by the Institute of Chartered Accountants of India lays down the accounting principles relating to valuation of inventories.

1. Inventories should be valued at historical cost or net realisable value whichever is lower subject to the following exceptions.

   (i) Inventory of consumable stores and maintenance supplies should be ordinarily valued at cost.

   (ii) Inventory of by products should be valued at lower of cost and net realisable value. Where cost of the by product cannot be determined separately, it should be valued at net realisable value.

   (iii) Inventory of reusable waste should be valued at raw material cost reduced by processing cost where facilities for reprocessing exist.

   (iv) Inventory of non-revisable waste or inventory of reusable waste for which facilities for reprocessing do not exist should be valued at net realisable value.

2. Historical cost represents the sum of

   - Cost of purchase (direct material)
   - Cost of conversion (direct labour, production overhead etc.)
   - Other costs incurred in bringing the inventories upto their present location and conditions.

3. The historical cost of manufactured inventories may be computed by adopting either direct costing or absorption costing.

4. To determine historical cost, FIFO, LIFO or average cost will be used.

5. The accounting policy followed for valuation of inventories, including the cost formulae used should be disclosed in the financial statements.

6. Consistency is generally accepted as a fundamental accounting assumption.

Verification and Valuation of Fictitious Assets

Fictitious assets are not tangible. Their expenditure is considered as a capital expenditure. Preliminary expenses, brokerage, underwriting commission, deferred revenue expenditure are the examples of fictitious assets.

Preliminary Expenses

For verification and valuation of preliminary expenses, the auditor should examine the statutory report, memorandum of association, articles and prospectus. Only the items connected with the flotation of the company are included in preliminary expenses. Expenses of the following nature are considered as preliminary expenses.

- Legal expenses of registering the company.
- Stamp duty and fees paid on authorised capital.
- Fees and stamp duty paid on documents filed with the Registrar of joint stock companies.
- Cost of preparing and printing memorandum and articles of association.
- Cost of preparing all preliminary agreements.
- Cost of preparing, printing and publishing prospectus.
- Engineer and valuer fees for valuing assets intended to be bought debentures, trust deed etc.
- Cost of the first set of books of account, statutory and statistical books and common seal of the company.
- All legal and professional charges for the formation of the company.

The auditor should thoroughly examine the contract with vendors to ascertain if they had to bear either the whole or a part of these expenses. The amount of preliminary expenses to be borne by the vendor or promoters should be charged to their account.

Preliminary expenses are to be shown separately on the asset side of the balance sheet till they are completely written off.

Brokerage

The amount paid towards brokerage should be verified in the following manner.

(i) The content of the articles of association should be studied. Its provisions affecting payment of brokerage should be taken note of.

(ii) The relevant portion of the prospectus dealing with the item of brokerage should be thoroughly studied to ascertain entitlement to brokerage.

(iii) The entitlement of the company in respect of brokerage should be verified with reference to application forms marked by the broker.

(iv) For the authorisation of the payment towards brokerage, broker's receipt and director minutes should be examined.

Underwriting Commission

For the verification of underwriting commission, the auditor should:

(i) Verify the terms of underwriting commission from the articles of association, prospectus and agreement with underwriters.

(ii) See that the limits laid down by the Controller of Capital Issues for underwriting commission are not exceeded.

(iii) Check the calculation of underwriting commission and verify payees' acknowledgment in respect of the said amount paid in cash.

(iv) Check the relevant entries for underwriting commission paid in the form of allotment of shares.

(v) See that underwriting commission is shown separately in the balance sheet till it is written off.

Deferred Revenue Expenditure

Deferred revenue expenditure represents a heavy expenditure incurred in the nature of revenue. Its benefits extend to several years to come. Such an expenditure is to be temporarily capitalised and to be amortised over certain number of years for which benefits are expected to be reaped. Examples of deferred revenue expenditure include:

(i) abnormal heavy amount of advertising in any one year to popularise a new product introduced in the market.

(ii) Cost of moving a business to a more convenient place.

(iii) Exceptional repairs of plant, buildings etc.

Verification of Contingent Assets

A contingent asset is one whose value, existence and title depend upon the occurrence or non-occurrence of a specified event or upon the performance or non-performance of a specified act.

Examples of contingent asset include:

- An option to apply for shares of another company.
- Refund of octroi paid for goods, which have been sent out later.
- Bills discounted which might be dishonoured.
- Uncalled share capital of a company.
- Consequences of infringement of a copyright.
- Legal proceedings for recovery of bad debts.
- Claim for damages in cash of breach of copyright, trademark or patent owned by the company.

Provisions of the Companies Act, 2013 do not require contingent assets to be disclosed as a footnote to the balance sheet.

However, it is fair on the part of the auditor to see the contingent assets as a footnote if their disclosure will exhibit a true and correct position of a balance sheet.

Verification and Valuation of Assets and Liabilities-II

A liability refers to a state of being under legal obligation. Liabilities are the financial obligation to third parties. If liabilities are not properly verified and valued, the balance sheet of an organisation will not reveal a true and fair view of its state of affairs. Liabilities stated in the balance sheet must be genuine and duly authorised. While auditing the liabilities, the auditor should obtain a certificate from a responsible official as to the correctness of liabilities. All liabilities existing on the date of the balance sheet should be included in the books of account. All the contingent liabilities should be disclosed in a footnote to the balance sheet.

It is incumbent on the part of the auditor to see that:

(i) All liabilities have been clearly stated in the balance sheet.

(ii) All liabilities as shown in the balance sheet relate to the business.

(iii) They are genuine and duly authorised.

(iv) All liabilities that appear in the balance are at their correct values.

The present chapter discusses verification procedures of various items of liabilities such as:

- Share capital
- Debentures
- Trade creditors
- Amounts due to subsidiary companies
- Loans
- Bills payable
- Provision for taxation
- Proposed dividend: and
- Contingent liabilities.

1. Share Capital

As per going concern principle, capital is not a liability. Still the auditor is required to verify the correctness of it.

While verifying the share capital of a company, the auditor should:

(i) Verify the "authorised share capital" with the relevant clause of the memorandum of association.

(ii) Call for a list of shareholders and check it with the register of members.

(iii) Verify entries for fresh issues, rights, bonus, calls etc.

(iv) In case of forfeiture of shares, the auditor should satisfy himself on the following points.

(a) See that procedures as laid down in the articles relating to forfeiture of shares were followed.

(b) Verify the entries for forfeiture of shares and see that necessary adjustments were made in the register of members.

(c) See that the reissue of forfeited shares was authorised by directors and the amount of discount did not exceed the amount already received on forfeiture.

(d) See that any capital profit on reissue is transferred to capital reserve.

(v) Examine the relevant provisions of Reserve Bank of India, if shares were allotted to foreign nationals.

(vi) In case of redeemable preference shares, verify the terms on which they were issued with reference to prospectus.

(vii) Examine the rights vested in shareholders holding various types of shares.

(viii) See provisions of the Act in respect of any reduction of share capital.

In case of a firm, the auditor should verify the capital with the help of partnership deed, cash book and the pass book.

2. Debentures

In case of debentures the auditor should:

(i) Examine the memorandum and articles of the company to ascertain the power of the company to issue debentures.

(ii) Examine the director's minutes regarding the issue of debentures and the mortgage of company's property where directors are empowered to borrow on behalf of the company.

(iii) Inspect the debenture trust deed to ascertain the amount of debentures issued and securities offered.

(iv) Obtain a certificate from the debentureholder to confirm the amount of debentures issued.

(v) In case of redemption of debentures, vouch the terms of redemption with the minutes on redemption.

(vi) See that premium or discount on issue of debentures are properly dealt with in the records.

(vii) Verify the register of charges and register of debenture holders and see that debentures stated in the balance sheet agree with debentures recorded in the books of account.

3. Trade Creditors

For verification of trade creditors, the auditor should:

(i) Obtain a schedule of creditors from the client and verify it with purchase ledger, cash book, creditors, statement of account, returns outward book, invoices, etc.

(ii) Confirm that goods purchased were actually received. For this purpose, inspect the goods inward book. Verify that all goods received before the close of the year are duly accounted for.

(iii) Ensure that all purchases made during the year have been properly accounted for. Purchases made at the end of the year deserve special care.

(iv) Inspect the credit entries for discounts, returns, rebates etc., made in the supplier's account with statement of accounts obtained from them.

(v) Compare return outward book with the ledger accounts and confirm that all the returns are supported by the credit notes of the supplier.

(vi) Probe the balance outstanding for a long period and find out the reasons for the same.

(vii) Compare the percentage of gross profits of the year under audit with that of the previous year. Find out if the variation is due to omission of purchases or inclusion of fictitious purchases.

(viii) Verify the purchase invoices relating to the period immediately after the close of the year under audit.

(ix) In case of hire purchases, see that the terms of hire purchase agreement are duly complied with.

4. Loans

To verify loans, the auditor should:

(i) Examine the memorandum and articles to confirm the borrowing powers of the company.

(ii) Verify the existence of loans with reference to correspondence made, contracts and director's minutes.

(iii) Ascertain the terms of loan, amount of loan, period and nature of loan plan of repayment, type of charge etc., by referring to the loan agreement.

(iv) Confirm the balances of unpaid loans from the creditors of the company.

(v) In respect of bank loans and overdraft, examine the agreement with the bank and also obtain a certificate from the bank to that effect.

(vi) See that interest on loan has been paid upto date. If not, see that the interest due is recorded as unpaid in the books of accounts.

(vii) In respect of loans from subsidiary company, examine whether the subsidiary company is authorised to lend to the holding company; Verify the balance sheet of the holding company and subsidiary company to ensure that an appropriate disclosure is made in this respect.

(viii) Prepare a movement account during the year and tie up the opening and closing balance of the loan.

5. Bills Payable

While verifying the bills payable, the auditor should:

(i) Obtain a schedule of bills payable and compare it with bills payable book.

(ii) Check the casts of the schedule. Its total should agree with bills payable account.

(iii) Verify the unpaid bills. Examine their subsequent payments with cash book of the succeeding period.

(iv) See that no bills payable are left out and not entered in the books of ccount.

(v) Obtain confirmatory statements from the drawers whom bills of large amount, if any, have been issued.

(vi) Check the calculation of interest accrued on bills payable.

(vii) Go through the running number of bills issued and examine the counterfoils with the bills payable register, if bills payable were issued out of a regular counterfoil book.

(viii) See that the originals of the cancelled forms together with the counterfoils are maintained.

6. Provision for Taxation

Taxation is an important liability. Its non-compliance would be a heavy burden. The auditor while verifying the provision for taxation should:

(i) Ascertain (by discussion and study of the tax files) the stage upto which the assessment procedures have been complied with.

(ii) Enquire whether any appeals are pending and examine the relevant documents of appeals and watch their implications.

(iii) Check the amount of tax liability computed keeping in mind the nature of business carried out by the entity.

(iv) See that the provision made is sufficient to meet the estimated liability for the year and to the date of balance sheet.

(v) See that correct adjustment has been made to the provision for taxation upon completion of assessments.

7. Proposed Dividend

For verification of proposed dividend, the auditor should:

(i) Study the provisions in the memorandum and articles in re payment of dividends.

(ii) See that proposed dividend does not include unpaid dividends must be shown separately in the balance sheet.

(iii) See that the amount of proposed dividend recommended by th of directors is stated in the balance sheet.

(iv) Verify that sufficient profits are available for the appropria proposed dividends.

8. Contingent Liabilities

A contingent liability is contingent on the happening or not happenin event. It is usual to record contingent liabilities in the books of ac Contingent liabilities may or may not arise in the future for payment. The should ensure that all known and unknown liabilities have been brought i accounts at the date of the balance sheet and shown separately.

Various contingent liabilities together with the verification procedu explained briefly.

i) Bills receivable discounted but not matured

It is usual that bills are discounted with the bank before their ma The auditor should check the amount of such bills with the bills receivabl and note the date of maturity.

He should trace the subsequent realisation of bills. Sufficient reserve i created for those bills which are dishonoured before the date of the audit

ii) Calls on Partly Paid Up Shares

The auditor should verify partly paid up shares with reference to certificates and banker's receipt for payment of application and allotment m

iii) Guarantees

The auditor should examine the agreements for guarantees. He shoul enquire whether the third party has deposited any amount by way of sec He should further ascertain from the creditor the amount of the outstanding

iv) Law suits

Some claims may not be admitted as debt by the client. In respect c pending law suits in this regard, the auditor should examine the correspon and development of the case. Adequate reserve should be provided for it, is likely to arise.

v) Arrears of Cumulative dividends

The auditor should examine the content of articles of association regar arrear of cumulative preference dividends.

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Chapter 12

Depreciation

The term depreciation is derived from the Latin word *depretium.* Split into "*de*" and :*pretium*" de means decline and pretium means price. So, the literal meaning of depreciation is decrease in the value of an asset. True profit can be calculated only after charging depreciation on assets. All assets are not depreciable. Only assets like building, plant, machinery, furniture etc., are subject to depreciation. It refers to the gradual diminution or loss in the utility value of an asset on account of wear and tear in use, efflux of time or obsolescence.

Definitions of Depreciation

Some important definitions of depreciation are given below.

1. Depreciation may be defined as a gradual deterioration in value due to use.

   —R.G.William

2. Depreciation may be defined as the measure of the exhaustion of the effective life of on asset from any cause during the given period.

   — Spicer and Pegler

3. It is a matter of common knowledge that all fixed assets such as plant, machinery, tools, buildings, leasehold, furniture etc., gradually diminish in value as they get older and become worn out by constant use in the business.

   —J.R.Batboi

4. In practice, the term depreciation is commonly used in a very wide sense, covering diminution in the values of assets caused by outside fluctuations in realisable and replacement values, and also the amortization of the cost of an asset over the period of its use.

   —De Paula and De Paula

5. Depreciation is the diminution in the financial value of the asset owing to wear and tear, effluxion of time, obsolescence or similar cause, the suggestion being other that of gradual deterioration than sudden loss or diminution in value.

   —L.C.Cropper

6. Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion, of time or 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.

—Accounting standards issued by the Institute of Chartered Accountants of India

Characteristics of Depreciation

A careful examination of various definitions of depreciation reveals the following characteristics.

(i) Depreciation is calculated on the value of the depreciable assets, like building, plant, machinery, furniture loose tools etc.

(ii) It is a permanent and continuous decreasse in the value of an asset.

(iii) Depreciation is caused due to use, efflux of time, obsolescence etc.

(iv) Depreciation is charged to spread the cost of an asset over its useful life.

Depreciable Assets

According to Accounting Standards issued by the Institute of Chartered Accountants of India depreciable assets are assets which:

(i) are expected to be used during more than one accounting period.

(ii) have a limited useful life and.

(iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

Meaning of Useful Life

Accounting to AS 6, useful life is either:

(i) The period over which a depreciable asset is expected to be used by the enterprise or.

(ii) The number of similar units expected to be obtained from the use of the asset by the enterprise.

Depreciable Amount

Depreciable amount of an asset is its historical cost, or any other amount substituted for historical cost in financial statements minus the estimated residual value at the end of useful life.

Historical cost includes:

- Purchase price
- Initial delivery and handling cost

- Installation cost
- Professional fees paid to architects, engineers etc.
- Financial cost like interest on deferred credit or borrowed fund for acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets.

After the assets are ready for use such financing costs should not be included.

- Expenditure incurred on start-up and commissioning of the project including expenditure on test runs and experimental production.

Administrative and other overheads are excluded from the historical cost of fixed assets.

Causes of Depreciation

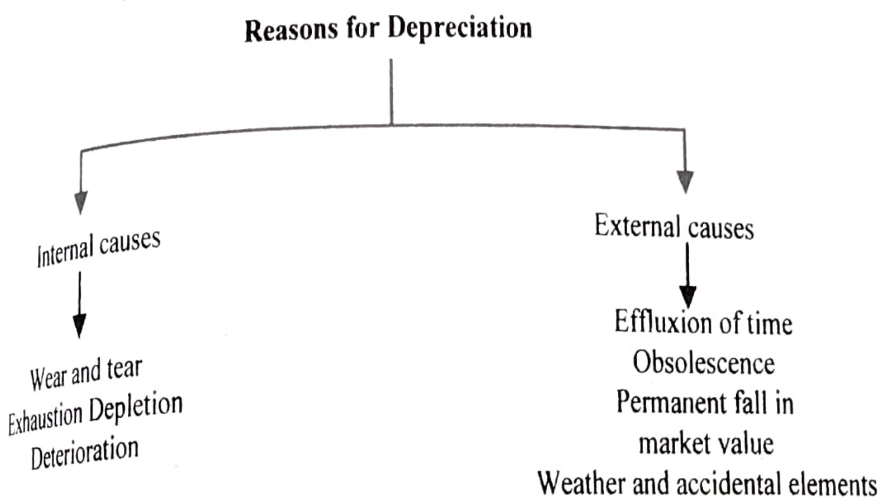

Figure 12.1 - Causes of Depreciation

Causes of depreciation may be of two: *internal causes* and *external causes*.

Internal Causes

Wear and tear, exhaustion, depletion, deterioration etc., causes depreciation of assets which are internal in nature.

Wear and tear

Assets diminish in their value as they are constantly used in the organisation. The difference between the value of an asset when it was bought and its value being used for sometime represents wear and tear. Although assets are kept in working conditions, a time comes when only scrap value remains.

Exhaustion

Assets lose their value with the passage of time. Consequently, productivity declines. Assets exhaust their value and are found useless after the elapse of a certain fixed period. It is true that assets have their definite age.

(vi) To keep capital intact

Keeping the capital intact has always been the focal point in business. The amount of depreciation charged against every year's profit should be appropriate. Omission or understatement of depreciation results in inflated profit. If any dividend is distributed out of inflated profit, it would be an incorrect return on capital. It will cause the value of the business to decrease. Capital should be kept intact.

(vii) To plan tax liability

Tax planning is the legitimate right of every assessee. Depreciation can be used as a tax saving device. It is an admissible expense while computing income from business. Income tax liability is reduced by claiming depreciation. A suitable depreciation policy is always essential to minimise tax liability.

Factors Affecting Depreciation Calculation

Certain factors enter into consideration for determining depreciation.

- Value of assets
- Estimated working life
- Repairs and renewal
- Addition and extension
- Scrap value
- Loss of interest on capital invested
- Legal provisions

1. Value of Assets

Value of depreciable asset is the cost of the same asset that represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to improvements thereof.

An increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors may cause changes in the historical cost a depreciable asset.

2. Estimated Working Life

Working life is determined by

- Legal or contractual limits such as the expiry dates of related leases.
- Extraction or consumption.
- Extent of use and physical deterioration on account of wear and tear which again depends upon operational factors like number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise.

3. Repairs and Renewals

Repairs and renewals keep the assets in good working condition. A well maintained asset yields good results over its stipulated life. If it is poorly maintained, it will become useless after a short period. So, repairs and renewals are an important consideration while determining the amount of depreciation.

4. Additions and Extensions

Additions and extensions are normally made to existing assets like plants and buildings. The purpose is to increase their capacity. Expenditures on additions and extensions are of capital nature. The dates of incurrence of such expenditures are considered to ascertain depreciation.

5. Residual Value

Scrap value of an asset represents the amount which the assets will fetch when discarded. Residual or scrap value of the assets should be deducted from their original cost.

6. Obsolescence

An asset is likely to become outdated due to change in technology. The possibility of an asset going out of fashion should be carefully weighed while calculating the amount of depreciation.

7. Loss of Interests

The purchase of an asset involves a heavy sum. It may be alternatively invested elsewhere. So, capital involved in the purchase of an asset implies a loss of interest on alternative investment.

8. Legal Requirements

Provision for depreciation on assets is subject to the Income Tax Act and Companies Act. Their legal provisions do enter into calculation of depreciation.

Methods of Providing Depreciation

There are various methods of providing depreciation. Some important methods are given.

- Straight-line method
- Written down value method
- Sinking fund method
- Depreciation fund method
- Insurance policy method
- Annuity method
- Sum of the digits method
- Revaluation method
- Depletion method

- Machine hour rate method
- Production unit method
- Renewals method

'Straight Line Method

A fixed percentage of original cost is written off on the asset every year. The annual depreciation charge remains constant over the entire useful life of a depreciable asset.

The amount of depreciation may be computed with the following formula.

$$\frac{\text{Cost} - \text{Estimated residual Value}}{\text{Estimated life}}$$

This method is simple to apply. It is easy to provide depreciation for those assets the working life of which can be easily estimated.

Examples: Copyrights, patents, plant and machinery etc., However, it has limitations.

(i) The expense of repairs and maintenance increase as the assets grow older. So the profit and loss account in the later years has more than its share of valuation.

(ii) It is difficult to calculate depreciation on additions made during the year.

2. Written Down Value Method

It is differently known as diminishing balance method, reducing balance method or declining balance method.

Depreciation is charged as a fixed percentage every year on the reduced balance of the asset.

Merits

(i) The charge against the profit and loss account in respect of depreciation and repairs and renewals remains almost uniform over years.

(ii) There is no need for separate calculations for any addition during the year as the depreciation is calculated on the total book value an asset at the end of the year.

Demerits

(i) The value of an asset could not be reduced to its residual value.

(ii) Interest on capital invested in the asset is not considered.

(iii) According to De Paula, this method has resulted, in a number of cases in totally inadequate provisions for depreciation.

3. Sinking Fund Method

A fixed amount is charged as depreciation to the profit and loss account and the same amount is credited to sinking fund account every year during the estimated life of the asset. The amount charged is invested in marketable securities. When the asset becomes unserviceable, the securities are realised. A new asset is bought out of the sale proceeds.

Merits

(i) When replacement is due, funds will be readily available.

(ii) It is easy to implement. Asset account remains at its original value. At the end of the life, it is written off against the sinking fund.

Demerits

(i) This method has no generally accepted accounting principles.

(ii) The whole of depreciable asset is not allocated over its useful life.

(iii) Sales proceeds of amount may not be enough for replacement.

4. Depreciation Fund Method

This method is very similar to sinking fund method. But the fund amount is invested within the firm. So, the cost of capital is used as the interest rate for computing the annuity sum.

The amount of depreciation goes on accumulating till the asset is worn out. The amount is available for replacement of the asset. Every year the same amount of depreciation charged to profit and loss account through creation of depreciation fund.

5. Insurance Policy Method

The business takes a policy from an insurance company. At the end of the working life of an asset, the amount required for the replacement of the asset is mobilised from the maturity of the policy. Cash which is equal to the amount of depreciation is paid by way of premium till the policy matures.

Merits

(i) It is very simple. No complicated calculations are involved in accounting them.

(ii) Funds are readily available for the replacement of the worn out asset.

Demerits

(i) This method is not suitable for assets added during the year.

(ii) It is difficult to implement the method where the working life of an asset cannot be estimately accurately.

6. Annuity Method

The annual depreciation is a assumed to cover not only an appropriate portion of the cost of the asset but also a fair share of interest on investment in the asset.

The amount to be written off as depreciation is calculated from annuity table. It is based on the rate of interest to be charged on the capital outlay and expected life of the asset. This method is advantageous where the assets are with a long life requiring huge capital outlay such as long term leases.

Annual depreciation is calculated as follows:

Cost – Present Value of residual value

Present Value of annuity of Re 1 for "n" years

"n" is useful life of the asset in years.

7. Sum of the Years' Digits Method

This method is similar to written down value method. There are larger amount of writeoffs in the earlier years while later years see smaller write - offs during the useful working life of the asset.

The amount of depreciation is calculated in the following manner.

No of years including the current year of the remaining life of the asset.

Total of all digits representing the life of the assets in years.

8. Depletion Method

This method is followed in respect of wasting assets. The depleting rate is worked out by dividing the investment in the assets by the number of physical units or quantity estimated to be extracted. Depreciation is arrived at by multiplying the depletion rate with the number of units or quantity actually extracted during the period.

This method is used in case of mines, quarries etc., from which certain quantity of output is expected to be extracted.

9. Revaluation Method

In case of small items like cattle, loose tools bottles etc., revaluation method works satisfactorily.

Assets are revalued at the end of every accounting year. This value is compared against the value of the assets at the beginning of the year. The difference between the two represents depreciation.

Appreciation in value on account of market fluctuations is ignored.

Technical experts undertake revaluation assuming the going concern concept.

10. Machine Hour Rate Method

The life of a machine is estimated in working hours. Cost minus residual value is divided by the number of such working hours. The resultant amount represents

The hourly rate of depreciation. Annual depreciation is arrived at by multiplying the hourly rate with the number of hours a machine has to run in a particular year.

Expensive machines with limited life are subject to hourly rate of depreciation.

11. **Production Unit Method**

Depreciation is provided on the basis of number of units of an item produced by the asset. Depreciation per unit is calculated as follows.

Depreciable amount is historical cost minus residual value. This method is suitable for the assets used directly in production for homogeneous output.

However, this method ignores depreciation that arises on account of effluxion of time. The computation of depreciation rate and periodic depreciation is a complicated exercise.

12. **Renewals Method**

While physical life of the fixed assets is virtually unlimited, their economic life depends on the degree of maintenance. If maintained regularly, some fixed assets are likely to serve for a very long period.

Tunnels, bridges, railway lines etc., are no exception to this. What is unique under this method is that the assets are not depreciated and only the expenditure on repairs and maintenance is charged to profit and loss account. A provision for repairs and maintenance is created by yearly transfers from the profit and loss account. That is the actual expenditure is set off against the provision.

Assets are written off in the event of obsolescence, demolition or abandonment.

Changing the Methods of Depreciation

According to Accounting Standards 6' the depreciation method selected once should be applied consistently. However, change in method is permitted where

(i) a new method is required by the statute.

(ii) a new method is required in compliance with an accounting standard or

(iii) a change will result in a more appropriate preparation or presentation of the financial statements.

If depreciation method is changed, the depreciation under the new method is calculated right from the beginning of the asset's life.

There are two alternative method of dealing with a change in the method of providing depreciation.

1. As per Accounting Standard 6 " when a change in the method of depreciation is made, the unamortized depreciable amount of the asset should be charged to revenue over the remaining useful life by applying the new method.

2. According to the statement of changes in the mode of charging depreciation issued by the Institute of Chartered Accountants of India (Prior to Publication of As 6)

(a) depreciation should be recalculated from the date of the asset coming into use.

(b) Any surplus arising out of the change in the method of charging depreciation should be transferred to general reserve through profit and loss appropriation account. Deficiency if any should be made up by debiting the general reserve through the profit and loss appropriation account.

(c) Full depreciation for the year in which the method of depreciation is changed, should be calculated under the new method and debited to profit and loss account of the year.

Disclosure of Change in the Method of Providing Depreciation

Accounting Standard 6 recommends that a change in the method of depreciation should be treated as a change in the accounting policy.

Disclosure Norms

Disclosures are to be made in the financial statements regarding depreciation as required by AS 6 and Companies Act.

1. Disclosured Under AS 6

(i) The financial statement should disclose the following along with the disclosure of other accounting policies.

- Depreciation methods used.
- Total depreciation for the period for each class of assets.
- The gross amount of each class of depreciable assets and the related accumulated depreciation.

(ii) If depreciable assets are revalued and it has a material effect on the amount of depreciation, the same should be disclosed separately in the year of revaluation.

(iii) A change in the method of depreciation is treated as a change in the accounting policy and it should be disclosed separately.

2. Companies Act, 1956

Sections 205, 349 (4) K and 350 deal with depreciation. Section 350 states that the amount of depreciation to be deducted shall be the amount of depreciation on assets as shown by the books of the company at the end of the financial year expiring at the commencement of this Act or immediately thereafter and at the end of each subsequent financial year at the rate specified in Schedule XIV.

Reserves and Provisions

Reserves

Reserve represents a portion of profit retained for a specific or a general purpose. It may be for payment of dividend, replacement of asset, diminution in the value of asset, etc. Reserves are created through transfers from profit and loss appropriation account.

Meaning and Definition of Reserves

1. Reserve means to retain or preserve for certain purposes.

– Oxford Dictionary

2. Reserve is defined as follows:

   (a) To keep in store for future or special use; to keep in reserve; to retain to keep as for one self.

   (b) To keep back; to retain or hold over to a future time or place.

   (c) To preserve.

– Webster's International Dictionary

3. Any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability.

– Part III of Schedule VI to the Companies Act, 1956

4. The use of the term reserve be limited to indicate that an undivided portion of the assets is being held or retained for general or specific purpose.

– American Institute of Accountants

5. Amount set aside out of profits and other surpluses which is not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet.

– The Institute of Chartered Accountants, England

6. A segregation or earmarking of retained earnings (earned surplus) evidenced by the creation of a subordinate account... The earmarking may be temporary or permanent, the purpose being to indicate to stockholders and creditors that a portion of surplus is recognised as available for dividends.

– Eric L. Kohler

From the above definitions, it can be concluded that reserve is a part of profit which is set aside for any known or unknown contingencies, liabilities, losses or diminution in the value of an asset in future.

Features of Reserve

Reserve has the following characteristics.

(i) Reserve is an appropriation of profit.

(ii) Reserve is created either out of current year's profit or accumulated profits of previous years.

(iii) It is provided to meet known and unknown future contingencies or unexpected loss.

(iv) It serves as an additional fund for working capital.

(v) It is not obligatory on the part of management to create reserve except statutory reserve.

(vi) Reserves can be used for the distribution or equalisation of dividends.

Classification of Reserves

Reserves are classified into six types. (i) general reserve,(ii) Specific reserve, (iii) Capital reserve, (iv) Sinking fund,(v) Reserve fund or development fund; and (vi) Secret reserve.

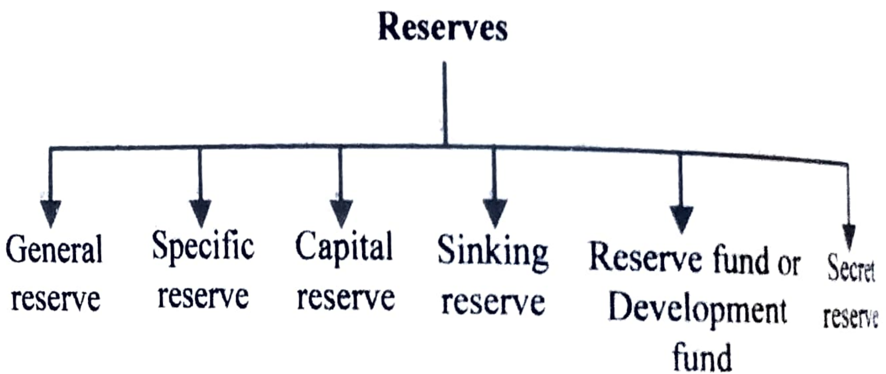

Figure 13.1 - Types of reserves

1. General reserve

A general reserve is created by appropriation of profits. A portion of net profit is withheld from being distributed to shareholders. It is the retained profit. It is technically known as "ploughing back of profit". It is created without any specific purpose. So, *free reserve* is the other name for it.

Reasons to create a general reserve

The broad aim of creating a general reserve is to assume future operating losses. It is created to

(i) Strengthen then the liquid resources of a business.

(ii) Meet unknown liability, contingency, commitments or diminution in the value of assets.

(iii) Provide additional working capital to the business.

(iv) Meet the requirements of capital assets or replacement of assets without issuing further shares or debentures.

(v) Provide additional funds to repay long term liabilities.

Auditor's Duty regarding General Reserve

Creation of a general reserve is purely the policy of the management. The auditor has to see that the general reserve is created in the interest of the business.

The auditor should:

(i) Examine the articles of association and see that the provisions in the articles are complied with in creating the general reserve.

(ii) See that the creation of general reserve is in the interest of the company. Creation of general reserve is not a legal requirement.

(iii) See that general reserve is created out of profits.

(iv) If general reserve is utilised for the payment of dividend, see that the amount drawn for the purpose is shown separately.

(v) If general reserve is invested in outside securities, see that such investments are shown separately in the balance sheet.

(vi) Where general reserve has been utilised, examine minutes of the board and see that the amount utilised is as per the board's decision.

(vii) Ascertain that proper disclosures have been made in respect of contributions to and withdrawals from the general reserve.

(viii) See that general reserve appears in the balance sheet properly.

Specific Reserve

A specific reserve is created for some specific purposes. Examples include dividend equalisation reserve, investment fluctation reserve, debenture redemption reserve etc., Specific reserve cannot be utilised for purposes other than those for which it has been created. A portion of profits or other surpluses are retained to meet specific requirements. It is not represented by any asset. So it cannot be utilised for distribution of dividend except in compelling circumstances.

The following are the differences between general reserve and specific reserve.

General reserve	*Specific reserve*
1. A general reserve is created for general purpose.	1. A specific reserve is created for some specific purpose.
2. It is created to strengthen the liquid resources of the company.	2. It provides for losses for which it has been created.

3. It is stated separately on the liabilities side of the balance sheet.	3. It is shown along with the item for which it has been created.
4. It is created out of undistributed profits. So it can be distributed as dividend to the shareholders in case of need.	4. It cannot be distributed as dividend except in compelling circumstances and at the discretion of the board of directors.

Auditor's Duty

In case of specific reserve, the auditor should:

(i) Verify the objective for which the specific reserve has been created.

(ii) See that provisions made are sufficient to meet the stated objective.

(iii) Disclose in his report the insufficiency of provisions made, if any, and ask the management to increase the provision to the desired level.

(iv) Verify that the reserve is properly shown on the liability side of the balance sheet.

(v) If the specific reserve holds any other purpose other than the stated one, see that the board has authorised it properly.

Capital Reserve

According to Part III of Schedule VI "the expression capital reserve shall not include any amount regarded as free for distribution through the profit and loss account.

Capital reserve is created out of profits or gains of capital nature. It is not created by transferring profit through profit and loss appropriation account.

Sources of capital reserve

Profits and gains of capital nature arise from the following sources.

- Profit on sale of fixed assets
- Profit on reissue of forfeited shares
- Pre - incorporation profits
- Premium on issue of shares or debentures
- Profit on redemption of debentures.
- Surplus on revaluation of fixed assets and liabilities.
- Profits arising from transactions of exceptional nature.
- Profits earned in purchase of a business.
- Capital redemption reserve fund.

The above profits do not occur in the regular course of business transactions. They are not distributable among shareholders. But they may be utilised for the

purpose of writing off intangible and fictitious assets like goodwill, copyrights, patent, preliminary expenses, discount on issue of shares or debentures or underwriting commission.

Generally, capital reserve is not created out of revenue profits. If the articles permit and the board of directors so desire, it may be created out of revenue profits.

Utilisation of Capital Reserve

Capital reserve is set aside to strengthen the company's financial position or to meet capital losses, which may arise in future course of action. Capital reserve may be utilised for the following specific purpose.

(i) To write off intangible and fictitious assets like preliminary expenses, cost of issuance of debentures and shares, discounts allowed, goodwill etc.

(ii) To issue bonus shares to the shareholders subject to provisions in the articles of association.

(iii) The premium received on issue of shares and transferred to capital reserve account can be utilised for the following purposes.

(a) For issuing bonus shares

(b) In writing off preliminary expenses

(c) In writing off commission or expenses or discounts etc., on the shares or debentures, and

(d) For providing premium on the redemption of redeemable preference shares or debentures.

Auditor's Duty

The auditor should:

(i) Carefully study the articles of association to see whether any clause pertaining to the capital reserve has been violated.

(ii) See that articles permit creation of capital reserve.

(iii) Ensure that capital reserves have been created out of capital profits only.

(iv) Verify the utilisation clause in the articles to ensure that capital reserve is utilised only for a specified purpose as mentioned in the articles or according to the provisions of the Companies Act, 2013.

(v) See that capital reserve is shown separately in the balance sheet.

(vi) Ensure that the effects of any addition and deduction in the capital reserve account have been taken into account.

(vii) Verify that capital reserves have not been mixed up with revenue reserve.

(viii) Examine the minutes of the meeting of board of directors to ensure that the amount utilised is as per the discussions in the meeting.

(ix) Ensure that provisions of Companies Act, 2013 are duly complied with while utilising the amount for dividend payment.

(x) Disclose in audit report any irregularity in respect of creation, addition, utilisation etc., detected.

Sinking Fund

A sinking fund is created for redemption of a debt or liability or for replacement of an asset in future.

"A sinking fund is created by the regular investment of such an amount as, with compound interest earned thereon, will accumulate to a given sum at the end of a stated period "(Justice Lancaster).

"A sinking fund is a form of specific reserve, set a side for the redemption of long term debt or the replacement of a wasting or depreciating asset"(Binnie and Manning).

Reasons to Create a Sinking Fund

(i) Redemption or repayment of a long term liability such as debenture, long term loans etc.

(ii) Replacement of any depreciable or wasting asset on the expiry of its expected life.

(iii) Renewal of lease.

Sinking fund is created by appropriating a portion of the profit every year and investing the same in gilt edged securities. The sale proceeds of securities can be utilised to redeem or replace a retiring asset.

Method of Creating Sinking Fund

Sinking fund may be created in two ways.

(i) By debiting profit and loss account.

(ii) By debiting profit and loss appropriation account.

By Debiting Profit and Loss A/c

Profit and loss account is debited every year with a certain sum of money. This money is invested in gilt edged securities or readily realisable securities. The sinking fund grows year after year with periodical contribution to the fund and interest on investments.

Money is realised at the end to replace a retiring asset.

By Debiting Profit and Loss Appropriation Account

This method is suitable for redemption of a liability.

Profit and loss appropriation account is debited every year with a certain sum of money. It should be invested in gilt edged securities to accumulate a specific sum of money for the repayment of a liability on a specific date.

In this method provision is made out of divisible profits.

Auditor's Duty

In respect of sinking fund, the auditor should:

(i) Study the clauses in the articles relating to creation and utilisation of sinking fund.

(ii) Scrutinise the obligations of the company to create the sinking fund.

(iii) Ensure that the amount transferred out of profits is sufficient to meet the liability.

(iv) Check the correctness of the amount transferred to the sinking fund with reference to the minutes of the meeting of directors.

(v) Ascertain that sinking fund investments are shown separately and its disclosure is proper.

(vi) See that the sums are invested in gilt edged securities which are safe and their rate of return is adequate.

(vii) See that sinking fund investments are realised on the due date and the profit or loss on such realisation is transferred to the sinking fund account only.

Reserve Fund or Development Fund

A sum set aside out of divisible profits is invested outside the business to meet any unexpected or unknown future contingencies or losses or to equalise dividends or to strengthen the financial position of a business.

Auditor's Duty

The auditor with regard to reserve fund should:

(i) Examine the minutes of directors and see that investments have been made according to the resolution of the board.

(ii) See that the reserve fund is shown separately in the balance sheet and not clubbed with any other reserve.

(iii) Physically verify the securities with the investment register.

(iv) See that the amount invested in outside securities is not less than the amount of reserve fund.

(v) See the purpose of the fund and verify its genuineness.

Secret Reserve

A secret reserve is one which is not disclosed on the face of the balance sheet. It is also known as *hidden reserve, internal reserve or inner reserve.* Though not apparent, the existence of secret reserve may be inferred from an

intelligent scrutiny of accounts. However, the exact amount is not easily ascertainable.

The existence of secret reserve implies that the net worth of the business is more than what is revealed the balance sheet.

Where the secret reserve exists in the business, the financial statements would not reveal the true and fair view of the financial statements. This is contrary to the provisions of the Companies Act. A joint stock company is prohibited to create secret reserves. But financial companies like the banking companies, insurance companies and electricity supply companies can create secret reserve. Like other reserves, secret reserves are created either to increase the financial stability and strength of the company or to provide for contingencies.

Sources of Secret Reserve

Secret reserves may be created by

- Charging capital expenditure to revenue
- Over valuation of liabilities
- Understatement of assets
- Inclusion of liabilities of fictitious nature
- Treating the contingent liability as actual liability
- Omitting certain items of assets from the balance sheet
- Crediting a revenue income to an asset account, and
- Charging over depreciation on fixed assets.

Objectives of Secret Reserve

Secret reserves may be created to:

(i) Provide additional strength to the financial position of the company
(ii) Provide for contingencies and unexpected emergencies.
(iii) Meet sudden future financial losses.
(iv) Maintain a stable dividend payment.
(v) Reduce tax liability by showing less profits.
(vi) Provide additional working capital.
(vii) Misguide the rivals on profitability position.
(viii) Distribute more profit to the shareholders, which is retained in the form of secret profit.

Limitations of Creating Secret Reserve

(i) With creation of secret reserve, there is considerable distortion in financial statements. As a result, it does not reveal a fair view of financial position of the company.

(ii) Shareholders, the real owners of a company are deprived of the right to know the true and fair view of the position.

(iii) Secret reserves are created by retaining a portion of divisible profits. With low dividend payment, the market value of the shares may be adversely affected.

(iv) Creation of secret reserve is known only to the persons at higher level of management. They may make illegitimate gains through sale or purchase of shares without the knowledge of shareholders.

(v) Secret reserve may be created by undervaluation of assets. If so, in case of destruction of assets, full value cannot be claimed from the insurance company.

Where secret reserve is created by omitting any asset, then there is always a scope for misappropriation of such assets by the directors or management of the company.

Auditor's Duty

The Companies Act prohibits the creation of a secret reserve except in the case of banking, insurance and electricity generating companies. If any other company creates a secret reserve, it will be against the spirit of the provisions. At the same time, if the auditor reports the existence of secret reserves to its members, the amount cannot be utilised in case of genuine needs. If the auditor knowing that a secret reserve exists and choose not to reveal the same, he will be liable for negligence for certifying the balance sheet and profit and loss account which were incorrect.

Where the secret reserve exists, the auditor should:

(i) Thoroughly examine the whole situation and refer the articles of association to ascertain the powers of directors to create secret reserve.

(ii) See that the amount is reasonable and it is being utilised properly for general welfare of company as a whole.

(iii) See that the real intention of creating a secret reserve is honest.

(iv) Carefully enquire into the object and necessity of creating secret reserve.

In the words of Silvoso and Baver, the auditor's position in case of the creation of secret reserves can be understood further.

"It causes misrepresentation of facts that may have been put deliberately or may be the outcome of an unintentional error. If the auditor is thorough in his examination of accounts and vigorously adheres to sound accountancy principles, he should discern a secret reserve of any substantial amount if it exists and he should end endeavour to persuade his client to correct his records.

In any event, the auditor should make full disclosure of his report in order to present to his client the final position clearly".

Judicial Rulings

1. Re Royal Mail Steam Packet Co. Ltd. (1931) It was held as follows:

"If the accounts from which dividends and expenses are paid are being fed by undisclosed reserves, it seems difficult to see how an auditor can possibly discharge his duty of giving a true and accurate view of the company's affairs without mentioning and drawing attention to the fact, which may be almost of vital importance as indicating the state of the company's affairs".

"No doubt an auditor in his important and delicate duties must use a certain amount of discretion, but whatever discretion he may feel justified in exercising, he must remember he is under statutory duty, and he may come under the penalties of law, if he fails in that duty...."

"The auditor is not concerned with questions of policy, but if he sees that there is something in the accounts to which he ought to draw the attention of the shareholders, it is his duty to do so. Either he will not sign the certificate at all or he will sign it with some qualifications, as the circumstances require".

2. Re Sham Dasani Vs Pochkhanwala (1927)

"The judge said, if any part of secret reserve is availed of to meet bad and doubtful book debts, it must be revealed in the balance sheet and not concealed".

3. Re Lord Kylsant's Case

It was held that "a very heavy or long, protracted utilisation of the secret reserves, in order to keep the company going is a serious matter which ought to be disclosed to the company.

4. Re Newton Vs Birmingham Small Arms Co. Ltd

Held that "any regulations which precluded the auditors from availing themselves of all the information to which under the Act they are entitled, as material for the report which under the Act they are to make as to the true and correct state of the company's affairs are, *e.g.*, think, inconsistent with the Act".

From the above, auditor's duty as regards secret reserves can be summarised as follows.

"The extent to which an auditor can pass secret reserves without comment is mainly a question of degree".

It is the duty of an auditor to report the matter in detail to the shareholders in the following circumstances.

(a) Secret reserves are not justified by the nature of the company's business or

) They are being drawn upon for paying dividends and meeting losses without disclosing the facts in the published accounts.

ovisions

rovisions are the amount set aside out of profits or other surpluses to meet fic requirements or commitments, the amount whereof can be estimated ely.

III of Schedule VI to the Companies Act defines provisions as follows.

"The provision shall mean any amount written off or retained by way of iding for depreciation, renewal or diminution in value of assets or retained way of providing for any known liability of which the amount cannot be rmined with substantial accuracy".

Thus provision means an estimated amount to meet a loss or expense in re whose amount as yet is uncertain. It must be noted that a provision is a rge against profit. It is not an appropriation.

ssification of Provisions

Provisions can broadly be classified into three categorises: (1) Provision for ses, (2) Provision for known liabilities and expenses and, (3) Provision for tingent liabilities.

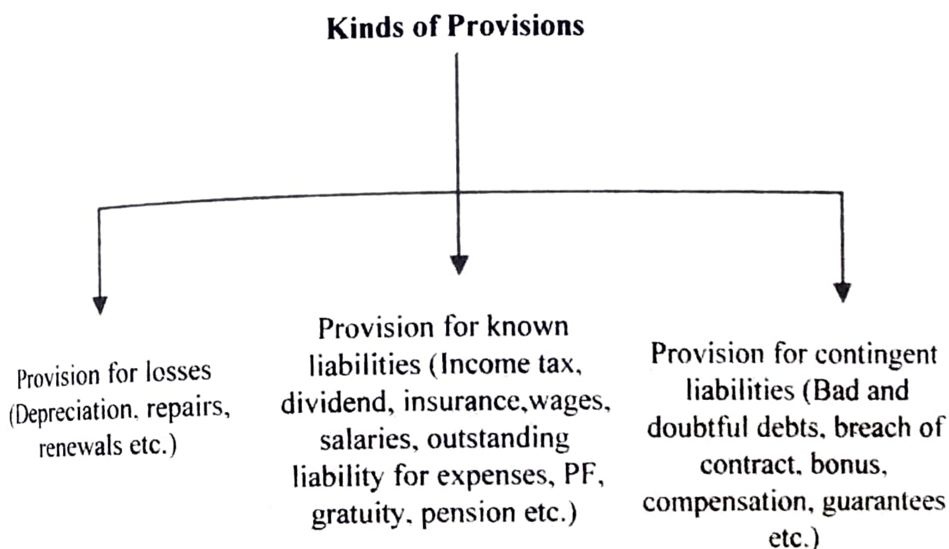

Figure 13.2 - Classification of provisions

(1) Provision for losses includes provision for depreciation, repairs, renewals or diminution in the value of assets.

(2) Provision for unknown liabilities and expenses includes provision for income tax, dividends, insurance, wages, salaries, outstanding liabilities for expenses, provident funds, gratuity, pension and similar other obligations.

(3) Provision for contingent liabilities includes provision for bad and doubtfuldebts, breach of contract, bonus, compensation, guarantees provided by the client in respect of third parties or own subsidiaries, payment of arrears of dividend for cumulative preference shares, disputed claims etc.

Auditor's Duty as regards Provisions

In respect of provisions, the auditor should:

(i) See that the amount of provision is sufficient as per the requirements and the objects for which it has been created.

(ii) Verify the articles of association and director's minute book in respect of provisions contained therein.

(iii) Ensure that all known losses and liabilities are provided for to their full value.

(iv) See that all the provisions created appear in the balance sheet.

(v) If provisions made are insufficient, advise the client to make necessary corrections in the accounts.

(vi) Disclose in his audit report any amount, method, or explanations given by the management is not satisfactory.

Differences between Reserves and Provisions

Though reserves and provisions are used interchangeably, they stand apart in some respects.

Sl.No	Basis	Reserves	Provisions
1.	*Creation*	Reserve is an appropriation of profits.	Provision is a charge against profits.
2.	*Optional or compulsory*	It is subject to availability of profit. It is not compulsory. It is the matter connected with business policy.	Creation of provision is compulsory.
3.	*Objects*	It is to strengthen the financial position of the concern and to meet unforeseen liabilities and losses.	It is created to meet a specific liability, loss or contingency.
4.	*Known or un known liability*	A reserve is an amount set aside for an unknown liability.	A Provision is a sum set aside for a known liability.

5. Treatment	Reserves are shown on the liabilities side of the balance sheet under the head 'reserves and surplus'. Because it is not made with reference to any specific asset.	Provision is shown as a deduction from the assets to which the loss may relate. For example, provision for bad debts is deducted from debtors, depreciation from concerned depreciable asset.
6. Distribution as dividend	Reserve represents undistributed profit. So, it can be distributed as dividend among shareholders.	Provision is not available for distribution as dividend. Because it can be applied only for the purpose for which it has been created.
7. Financial policy Vs. Financial urgency.	Creation of reserve depends upon the financial policy and discretion of the management of the company and availability of profits.	Provision is a matter of financial urgency. It must be provided for even if there is no profits.
8. Auditor's duty	The auditor must verify any any investments held by the company and financed by reserve fund. "He must qualify his report when he finds that a general reserve is non-existent to the extent of any over valuation of assets or accumulated revenue losses.	The auditor should see that the provision for loss or expense is sufficient. If it is inadequate and he is unable to get the figure of provision corrected in the accounts his duty is to mention the fact in his report.

Multiple Choice Questions

I. Choose the Best Answer from amongst the following:

1. Which one of the following is not a method of creating secret reserve?
   (a) Treating revenue expenditure as a capital expenditure
   (b) Suppressing accrued incomes and prepaid expenses
   (c) Overstatement of liabilities
   (d) Under valuation of assets

Appointment, Rights and Duties of Auditors

There has been a paradigm shift in the provisions relating to appointment of auditors. An auditor is an independent professional person qualified to perform an audit. Some important provisions of Companies Act, 2013 governing eligibility for appointment as auditor, appointment of auditor, rotation of auditors, audit committe formation, filling casual vacancy, resignation of auditor, removal and change of auditor, powers and duties of auditor and the like are discussed.

Eligibility, Qualifications and Disqualifications of Auditors

A person will be qualified to be appointed as an auditor of a company, only if he is a chartered accountant. Where a firm is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm. A person will be disqualified if he is falling under the following.

(i) An officer or employee of the company

(ii) A person whose relative is a director or is in the employment of the company's director or key managerial personnel.

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

Appointment of First Auditor

1. Under section 139(6), the first auditor shall be appointed by the Board within 30 days of incorporation.
2. If the Board fails, an extraordinary general meeting (EGM) shall be called within 90 days to appoint the first auditor. The law is silent from when this time limit of 90 days be reckoned. It is better to interpret that 90 days limit starts from incorporation rather than expiry of 30 days.

3. Tenure

The auditor will hold office till the conclusion of 1st general meeting.

4. Remuneration

As per proviso the section 142(1), remuneration of the first auditor can be decided by the Board.

5. Procedure

- Intimation is sent to the proposed auditor regarding the intention of appointing him as auditor, and he is asked whether he is eligible and not disqualified to be appointed as auditor of the company.
- A written consent and certificate from auditor are obtained.
- If audit committee is required to be consituted under section 177, its recommendation is obtained.
- Board meeting is called to appoint the auditor.

Appointment of Auditor at First AGM

Under section 139, every company shall, at the first annual general meeting appoint an auditor who can either be an individual or a firm.

Appointment includes reappointment.

The manner and procedure of selection of auditors by the members of the company will be such as may be prescribed.

1. Written Consent

Before such appointment is made, the written consent of the auditor to such appointment and a certificate from him shall be obtained from the auditor. The said certificate is to the effect that the appointment, if made, shall be in accordance with the conditions as may be prescribed.

2. Tenure

Company can appoint an individual as an auditor for more than one term of five consecutive years and an audit firm as an auditor for more than two terms of five consecutive years. The tenure of 5 consecutive years is subject to ratification by shareholders at every AGM.

3. Government Company

In a government company, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor.

Such appointment shall be 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.

4. Remuneration

Under section 142(1), remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be prescribed.

5. Manner and Procedure for Selection

- The Board or the audit committee (where it is required to be consituted) shall consider the qualifications and experience of the auditor and whether the aforesaid attributes are commensurate with the size and requirements of the company.

- Where the consitution of the audit committee is required, the committee shall recommend the name of the auditor to the Board. The Board, if it agrees with the recommendation, will further recommend it to the members.

6. Intimation to Auditor

The company shall inform the auditor regarding appointment and file a form ADT-1 with Registrar of Companies within 15 days of meeting in which the auditor is appointed.

7. Annual General Meeting

The Board calls the AGM, recommends the name of the auditor to members and gets the ordinary resolution appointing the auditor passed at the meeting.

Re-appointmnet of Auditor

After completion of tenure of 5 consecutive years, the auditor may be reappointed.

1. Conditions

The auditor may be reappointed at an annual general meeting if

- he is not disqualified for re-appointment.
- he has not given the company a notice in writing of his unwillingness to be re-appointed.
- a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be reappointed.

2. Consent, Certificate and Filing of Form

As per proviso to section 139(1) consent of auditor, certificate from him and filing of firm are required. Since appointment includes reappointment, the documentation and filing of form is required.

The procedure for re-appointment of auditor shall more or less be same as both appointment and re-appointment are governed through provisions of section 139(1).

Rotation of Auditors

As per section 139(2) no listed company as prescribed shall appoint or re-appoint

- An individual as auditor for more than one term of 5 consecutive years.
- An audit firm as auditor for more than two terms of 5 consecutive years.

Manner of Rotation

The procedure depends upon whether audit committee is required to be constituted or not.

- Where the consitution of the audit committee is required, the committee shall recommend the name of the auditor to the Board. The Board, if it agrees with the recommendation, will further recommend it to the members.

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The company shall inform the auditor regarding appointment and file a form ADT-1 with Registrar of Companies within 15 days of meeting in which the auditor is appointed.

7. **Annual General Meeting**

The Board calls the AGM, recommends the name of the auditor to members and gets the ordinary resolution appointing the auditor passed at the meeting.

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- a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be reappointed.

2. **Consent, Certificate and Filing of Form**

As per proviso to section 139(1) consent of auditor, certificate from him and filing of firm are required. Since appointment includes reappointment, the documentation and filing of form is required.

The procedure for re-appointment of auditor shall more or less be same as both appointment and re-appointment are governed through provisions of section 139(1).

Rotation of Auditors

As per section 139(2) no listed company as prescribed shall appoint or re-appoint.

- An individual as auditor for more than one term of 5 consecutive years.
- An audit firm as auditor for more than two terms of 5 consecutive years.

Manner of Rotation

The procedure depends upon whether audit committee is required to be constituted or not.

If such constitution is required, then the committee shall recommend to the Board the name of the auditor who may replace the incumbent audtior on expiry of his term. The Board shall consider the same and make its recommendation to the members.

Where committee is not required, then the Board shall itself recommend to the members.

Audit Committee and Rotation of Auditors

Conditions for audit committee (section 179 read with rule 6 of Companies (Meetings of Board and its Powers) Rules, 2014:

The following companies shall consitute audit committee.

- Listed companies
- Public companies with paid up capital of Rs. 10 crore or more
- Public companies, having turnover of Rs. 100 crore or more
- Public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs. 50 crore or more

Conditions for rotation of auditors (section 139 (2) read with rule 5

- Listed companies.
- Public companies with paid up capital of Rs. 10 crore or more.
- Private limited companies having paid up capital of Rs. 100 crore or more.
- All companies having paid up capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of Rs. 50 crore or more.

Companies to which audit committee applies but not rotation of Auditors

- Public companies having turnover more than Rs. 100 crore but paid up capital less than Rs. 10 crore.
- Public companies which have issued debentures or have borrowed money from other than bank, financial institution in excess of Rs. 50 crore.

Companies to which rotation applies but not audit committee

- Private companies having paid up capital of Rs. 100 crore or more.
- Private companies which have borrowed money from bank, financial institutions, in excess of Rs. 50 crore.

Casual Vacancy

As per section 139 (8) any casual vacancy shall be filled by the Board within 30 days.

...the vacancy has arisen due to resignation of auditor, then such appointment ...be approved by the comapny at a general meeting convened within 3 months ...recommendation of the Board.

...ces of casual vacany

- Death
- Resignation
- Disqualification
- Failure of ratification at annual general meeting

...an existing auditor gets disqualified under section 141, then he shall inform ...company and the situation will be treated as casual vacancy as per ...ion 141 (4).

...ure

An auditor appointed in casual vacancy shall hold office till conclusion of ...thcoming annual general meeting.

...muneration

Section 142 deals with remuneration of auditor. The section expressly ...powers the shareholders to fix the remuneration except in case of first auditor. ...e law is silent on fixing remuneration for auditor being appointed in casual ...cancy. Since the law being silent and going with the purposeful interpretation ...of law, remuneration can be decided by the Board as the appointing authority is ...e Board itself.

...ocedure

(i) Intimation shall be given to the proposed auditor regarding the intention of appointing him as auditor. He should be further asked whether he is eligiable and not disqualified to be appointed as auditor of the company.

(ii) Consent and certificate from the auditor should be obtained.

(iii) If audit committee is required to be constituted under section 177, its recommendation should be obtained.

(iv) Board meeting shall be called.

(v) At the Board meeting the appointment of auditor should be approved.

(vi) The auditor should be intimated and ADT–1 form should be filed with Registrar of Companies within 15 days.

...ocedure where casual vacancy arises due to resignation of existing auditor

(i) Proposed auditor should be intimated regarding the intention of appointing him as auditor.

He should be further asked whether he is eligible and not disqualified to be appointed as auditor of the company.

(ii) Consent and certificate from the auditor should be obtained.

(iii) If audit committee is required to be constituted under section 177, its recommendation should be obtained (section 139 (11)).

(iv) Board meeting should be called for

- Appointment of auditor in casual vacancy.
- Considering that the qualification and experience are commensurate with the size and operations of the company.
- Recommending the members to approve the appointment.
- Calling of EGM to be within 3 months from date of Board meeting.

(v) The auditor should be sent intimation. ADT – 1 form should be filed with the Registrar of Companies.

Resignation of Auditor

Under section 140(2), the auditor who has resigned from the comapny shall file within 30 days from the date of resignation a statement in the prescribed form with the company and Registrar of Comapnies. The statement shall indicate the reasons and other facts as may be relevant with regard to his resignation in form ADT – 3.

If the auditor does not comply with these requirements, he shall be punishable with fine of Rs. 50,000 to 5,00,000.

After the resignation the provision of casual vacancy shall be triggered.

Removal and Change of Auditor

Under the Companies Act, 2013 the following procedures govern the removal and change of auditor.

1. Special Resolution

The auditor appointed may be removed from his office before the expiry of his term only after a special resolution of the company. Previous approval of the Central Government shall be obtained in that behalf in the prescribed manner.

2. Resignation

(i) The auditor who has resigned from the company shall file within a period of thirty days from the date of resignation, a statement in the prescribed form with the company and the Registrar.

(ii) In case of government company the auditor who has resigned shall file such a statement with the comptroller and Auditor General of India within 30 days from the date of resignation.

(iii) While filing the statement reasons for resignation and other facts as may be relevant with regard to his resignation shall also be indicated.

(iv) In case of non-compliance, he shall be punishable with fine ranging from Rs. 50,000 to five lakhs.

3. Tribunal

The Tribunal either suo motu or on an application made to it by the Central Government or by any person concered may by order direct the company to change its auditors. The tribunal passes such order only when it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner in relation to the company or its directors or officers.

4. Consequences

(i) The auditor who is removed by the Tribunal cannot be appointed as an auditor of that company for five years.

(ii) The auditor who is removed shall be punishable with imprisonment for a minimum term of six months which may extend to ten years. He shall also be liable to pay a minimum fine of an amount involved in the fraud which may extend to three times the said amount.

(iii) If the fraud involves public interest, the minimum period of imprisonment will be three years.

Power and Duties of Auditors and Auditing Standards

The Compaines Act has conferred certain rights on duditors so as to enable them to discharge their duties smoothly.

Power

1. Right to Access

Every auditor of a company shall have right to access book of accounts and vouchers of the company.

The auditor can obtain from the officers of the company such information and explanation as he may consider necessary for performance of his duties.

The list of matters for which auditor shall seek information and explanation includes issues related to

(a) Proper security for loans and advances

(b) Transactions by book entries

(c) Sale of assets in securities in loss

(d) Loans and advances made shown as deposits

(e) Personal expenses charged to revenue account

(f) Cash received for share allotted for cash

The auditor of holding company has same rights.

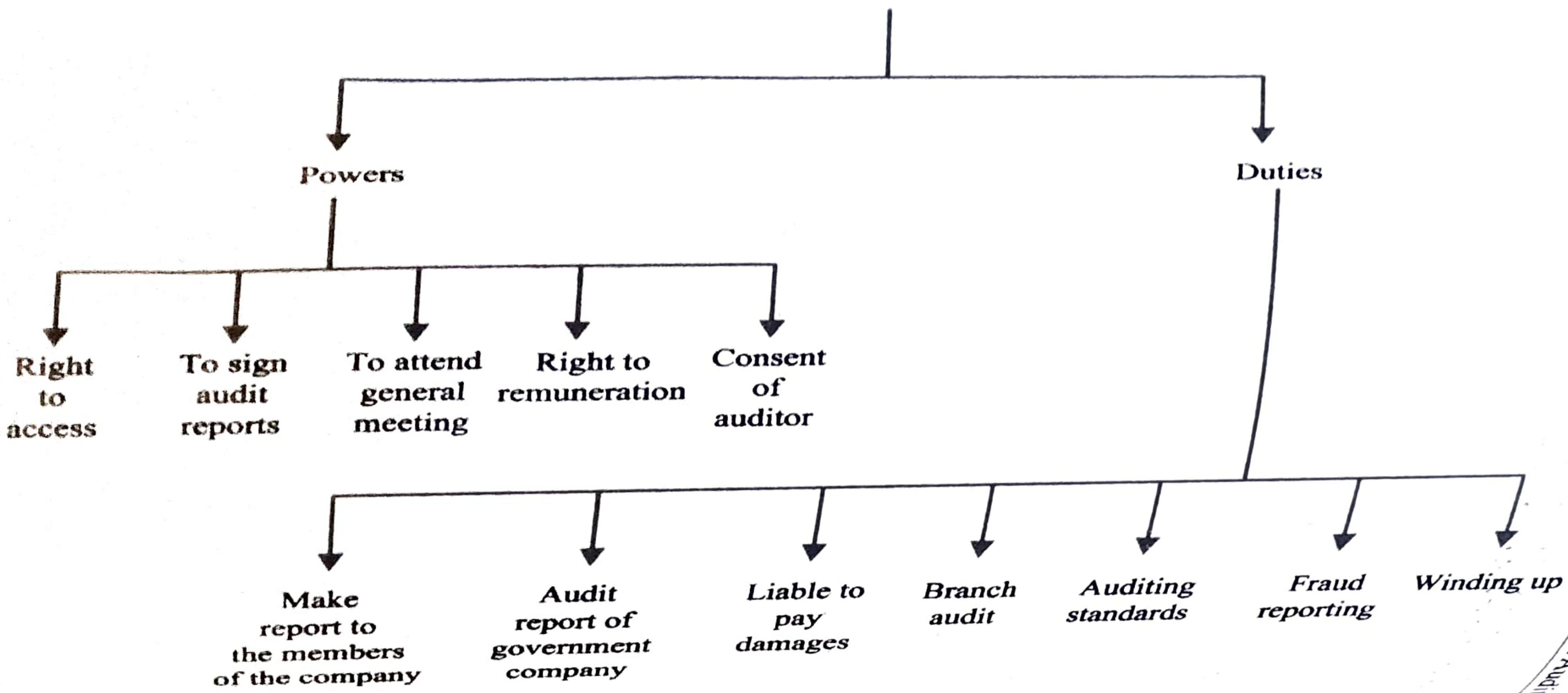

Figure 14.1 — Power and Duties of Auditors

2. Auditor to Sign Audit Reports

The auditor of the company shall sign the auditor's report or sign or certify any other document of the company and financial transactions which have any adverse effect on the functioning of the company mentioned in the auditor's report. The auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the comapny.

3. Auditor to Attend General Meeting

Under section 146, the company must send all notices and communications to the auditor relating to any general meeting.

The auditor shall attend the meeting either through himself or through his representative, who shall be an auditor.

The auditor in general meeting must be given reasonable opportunity to speak on any part of the business which concerns him as the auditor.

Under section 101, notice of general meeting must be given before 21 days to the auditor in such a manner as may be prescribed.

Every notice of a meeting shall specify the palce, date, day and hour of the meeting. It shall also contain a statement of the business to be transacted at such meeting.

4. Right to Remuneration

The remuneration of the auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.

It must include the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility extended to him. But it does not include any remuneration paid to him for any other service rendered by him at the request of the company.

5. Consent of the Auditor

Under section 26, the company must mention in their prospectus the name, address and consent of the auditors of the company.

Duties

1. Audit report to the Members of the Company

The auditor shall make a report to the members of the company on accounts and financial statements examined by him.

The report shall state:

(a) Whether he has sought and obtained all the necessary information and explanations.

(b) Whether proper books of accounts have been kept.

(c) Whether the company's balance sheet and profit and loss account are in agreement with books of accounts and returns.

2. Audit Report of the Government Company

The auditor of the government company will be appointed by the Comptroller amd Auditor-General of India.

Such auditor shall act to the directions given by them.

He must submit a report to them on accounts and financial statements of the company examined by him and also the actions taken in this regard.

The Comptroller and Audit-General of India within sixty days of receipt of the report have right to conduct a supplementary audit and comment on or supplement such audit report.

The Comptroller and Audit-General of India may cause test audit to be conducted of the accounts of such company.

3. Liable to Pay Damages

The depository and members of the company have right to file an application before the tribunal if they are of the opinion that the managment or conduct of the affairs of the company are being conducted in a manner prejudicial to the interests of the company.

4. Branch Audit

Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company or by any other person qualified for appointment as an auditor of the company.

The branch auditor shall prepare a report on the acounts of the branch examined by him. He shall then send that report to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

5. Auditing Standards

Every auditor shall comply with the auditing standards.

The Central Government shall notify standards in consultation with National Financial reporting authority.

The government shall also notify that auditor's report shall include a statement on such matters as notified.

6. Fraud Rerporting

If an auditor of a company suspects that an offence involving fraud is being committed by officers or employees of the company, he shall immediately report the matter to the Central Government in such manner as may be prescribed.

7. Winding up

Under section 305, at the time of voluntary winding up of a company it is a mandatory requirement that the auditor should attach a copy of the audits of the company prepared by him.

Appendix

Companies Act, 2013

Powers and duties of auditors and auditing standards

1. Every auditor of a company shall have a right of access at all times to the books of accounts and vouchers of the company, whether kept at the registered office of the company or at any other place and shall be entitled to require from the officers of the company such information and explanation as he may consider necessary for the performance of his duties as auditor and amongst other matters inquire into the following matters, namely:–

   (a) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

   (b) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the comapny;

   (c) Whether the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company;

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

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

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

   Provided that the auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statemetns with that of its subsidiaries.

2. 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.

3. 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 statement;

   (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 within 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 quaification, 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) such other matters as may be prescribed.

4. 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 therefor.

5. In the case of a Government company, the Comptroller and Auditor-General of India shall appoint the auditor under sub-section *(5)* or sub-section *(7)* of section 139 and direct such auditor the manner in which the accounts of the Government company are required to be audited and thereupon the auditor so appointed shall submit a copy of the audit report to the Comptroller and Auditor-General of India which, among other things, include the directions, if any, issued by the Comptroller and Auditor-General of India, the action taken thereon and its impact on the accounts and financial statement of the company.

6. The Comptroller and Auditor-General of India shall within sixty days from the date of receipt of the audit report under sub-section *(5)* have a right to,–

   (a) conduct a supplementary audit of the financial statement of the company by such person or persons as he may authorise in this behalf; and for the purposes of such audit, require information or additional information to be furnished to any person or persons, so authorised, on such matters, by such person or persons, and in such form, as the Comptroller and Auditor-General of India may direct; and

   (b) comment upon or supplement such audit report:

   Provided that any comments given by the Comptroller and Auditor-General of India upon, or supplement to, the audit report shall be sent by the company to every person entitled to copies of audited financial statements under sub section *(1)* of section 136 and also be placed before the annual general meeting of the company at the same time and in the same manner as the audit report.

7. Without prejudice to the provisions of this Chapter, the Comptroller and Auditor-General of India may, in case of any company covered under sub-section *(5)* or sub-section *(7)* of section 139, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company and the provisions of section 19A of the Comptroller and Auditor-General's (Duties, Powers and Conditions of Service) Act, 1971, shall apply to the report of such test audit.

8. Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company's auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company's auditor or by an accountant or by any other person duly qualified to act as an auditor of

the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company's auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.

9. Every auditor shall comply with the auditing standards.

10. The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, consituted under section 3 of the Chartered Accountants Act, 1949, in consulation with and after examination of the recommendations made by the National Financial Reporting Authority:

    Provided that until auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

11. The Central Government may, in consultation with the National Financial Reporting Authority, by general or special order, direct, in respect of such class or description of companies, as may be specified in the order, that the auditor's report shall also include a statement on such matters as may be specified therein.

12. Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed.

13. No duty to which an auditor of a company may be subject to shall be regarded as having been contravened by reason of this reporting the matter referred to in sub-section *(12)* if it is done in good faith.

14. The provisions of this section shall *mutatis mutandis* apply to –

    (a) the cost accountant in practice conducting cost audit under section 148; or

    (b) the company secretary in practice conducting secretarial audit under section 204.

15. If any auditor, cost accountant or company secretary in practice do not comply with the provisions of sub-section *(12)*, he shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.

Chapter 15

Auditor's Liabilities

The liabilities of the company auditors may be studied under four heads:

1. Statutory liabilities
2. Contractual liabilities
3. Liabilities under common law
4. Other liabilities.

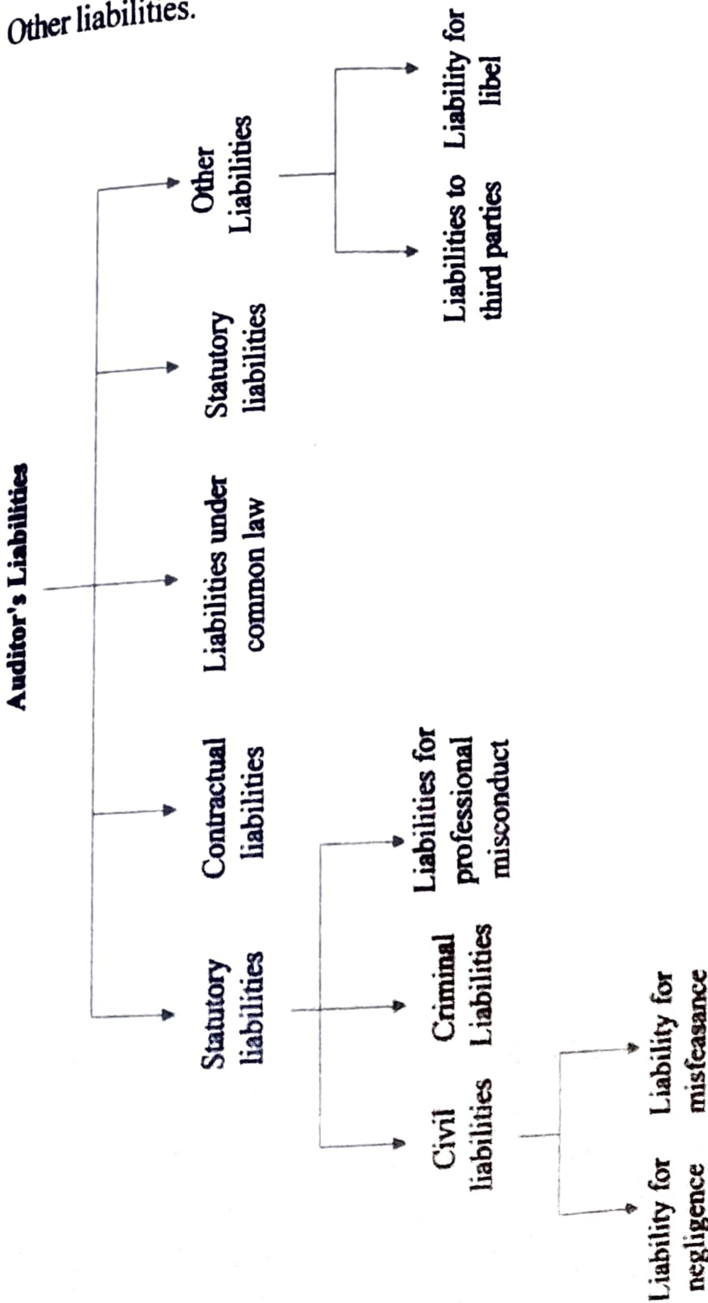

Figure 15.1 : Liabilities of company auditors

I. Statutory Liabilities

These are liabilities of auditors under statute. They can be further classified into

1. Civil liabilities
2. Criminal liabilities and
3. Liabilities for professional misconduct

1. Civil Liabilities

A civil liabilitity arises out of civil wrong for which losses or damages can be claimed by suing him in a civil court. Civil liability can be:

- Liability for negligence
- Liability for misfeasance

Liability for Negligence

Negligence means breach of duty. An auditor is an agent of the shareholders. He is to perform some duties. He should take reasonable care and skill in the performance of his duties. If he fails to do so, liability for negligence arises. An auditor will be held liable if the client has suffered loss due to his negligence. It should be noted that an auditor will not be liable to compensate the loss or damage if his negligence is not proved. This can be stated as under:

An auditor is not liable for:

- Loss without negligence
- Negligence without loss

An auditor may be indemnified by the company for any expense incurred by him while defending himself if he is acquitted by the court.

Liability for Misfeasance

Misfeasance means breach of trust or duty resulting a loss to the company. After a company has gone into liquidation, misfeasance proceedings can be initiated against the auditor by

- the liquidator or
- the creditor or
- a contributory of the company

The auditor is relieved from liability if he has acted honestly. The auditor has to satisfy the court about the fairness of his conduct to relieve himself from the liability.

2. Criminal Liabilities

Crime is any offence punishable by law. Criminal liability of an auditor arises out of an illegal act resorted to crime.

In the words of Lancaster "a criminal liability arises from errors in performance of audit duties involving criminal neglect or, of course, actual fraud or conspiracy in which intention to do what is known to be illegal is an essential element".

Criminal liabilities may be grouped into two.

- Under the Companies Act, 2013
- Under the Indian Penal Code

Criminal Liabilities Under the Companies Act, 1956

Sl.No	Section	Extent of liability
1	63	Mis statement in prospectus Auditor may be relieved from the punishment if he can prove either that his statement was immaterial or that he had reasonable ground to believe that the statement was true.
2	68	Fraudulently inducing persons to invest moneys and will be charged with penalty for the same.
3	233	An auditor's report or any document of the company is signed or authenticated which is not in conformity with the provisions of sections 227 and 229.
4	240	The auditor does not assist the inspector appointed by the Central Government to investigate into the affairs of the company.
5	242	If on the report of an inspector, the Central Government prosecutes any person connected with the affairs of the company, the auditor is should to assist the prosecution. If the auditor does not to do so, he may be punished as if he were juilty of contempt of court.
6	477	In the course of winding up, the auditor does not return to the court all the books and documents of the company in his possession. He fails to appear before the court.
7	478	On the application of the official liquidator, the auditor of a company can be publicly examined in the high court.

8	538	The auditor of a company being wound up (a) destroys, mutilates, alters, falsifies or is privy to the destruction, mutilation, alteration, falsification or secreting of any documents. (b) makes or is privy to the making of any false or fraudulent entry in any register, book of account or document of the company.
9	545	If he has been guilty of any offence, an auditor can be prosecuted by the liquidator of a company in winding up on the direction of the court.
10	628	The auditor makes a statement (a) which is false in any material particular, knowing to be false. (b) which omits any material fact knowing it to be material.
11	629	The auditor intentionally gives false evidence upon any examination on oath or solemn affirmation authorised Under The Act or in any affidavit, deposition or solemn affirmation in or about the winding up of any company Under The Act or other wise in or about any matter arising under the Act.

Criminal Liabilities Under the Indian Penal Code

Under section 197 of the Indian Penal Code whoever issues of signs any certificate required by law knowing that such certificate is false in material point, shall be punishable.

Section 633 of the Act deals with powers of the court to grant relief the auditor in certain cases.

If the auditor has acted honestly and reasonably by taking into consideration all the circumstances of the case, the court can relieve him wholly or partly on such terms it may think fit. However, the court has no power to relieve an auditor in case of any civil liability in a criminal case against him.

3. Professional Misconduct

The Chartered Accountants Act, 1949 specifies a number of acts and omissions that constitute professional misconduct in relation to chartered accountants in practice.

The cost and Works Accountants Act, 1959 Contains Provisions regarding professional misconduct in relation to chartered accountants and cost accountants in practice.

Section 21,22 and 23 of the cost and Works Accountants Act lay down the procedures of enquiry and appeal in cases relating to misconduct by cost accountants.

II Contractual Liabilities

These are liabilities of an auditor for breach of contract. Contractual liabilities arise because of auditor's failure to fulfil a contractual obligation.

As per Indian Contract Act, 1872 an auditor becomes liable to his client on his failure to perform duties undertaken by him.

III Liabilities Under Common Law

Common law is the ancient unwritten law of the nation binding on the whole community. It is founded on customs, developed by usage and made common throughout the land. They came to be embodied in the decision of the learned judges in the case laws. In varied and far reaching body of the case laws, customs and usage are found to be influencing forces.

IV Other Liabilities

Other liabilities of an auditor include

- Liabilities to third parties
- Liability for libel.

Liabilities to Third Parties

An auditor can be held liable for damages to third parties if they have suffered losses by relying upon any statement signed by him.

Tax authorities pass assessment orders on the strength of audited accounts.

Banks advance loans, insurance companies settle claims on the basis of audited accounts.

The authorities rel yon the information conveyed to them through the figures of audited balance sheet and profit and loss account.

However, if there is no fraud, it would appear that an auditor cannot be held liable in respect a loss sustained by third party. (*Le Lievre* and *Dennes* Vs. *Gould* (1893)).

In *Derry V.s Peek* (1889), it was held that if a third party wanted to hold the auditor liable for damages, the following should be proved.

(i) That the statement or balance sheet signed by the auditor was materially untrue.

(ii) That the auditor knew that the statement etc., were true .

(iii) That the statements etc., were made with an intent that a third party should act on it.

(iv) That the third party did act upon such statement and consequently suffered loss.

Liability for Libel

The audit report is considered as a privileged document. The auditor should submit his report in a manner which may not result in exposing him to action on grounds of defamation.

To be free from liability for libel, the following ingredients should be present in the report.

(i) It does not misstate facts.

(ii) It is not actuated by malice.

(iii) It does not go beyond what is relevant to its subject.

(iv) The statement made is bonafide.

Liabilities of Auditors under Companies Act, 2013

1. Penalty Levied by Tribunal

The Tribunal either suo motu 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 acted in a fraudulent manner in relation to the company it may direct the company to change its auditor.

In the case of such an application by the Central Government for change of auditors, the Tribunal can, within 15 days, pass an order that the auditor shall not function as such and the Central Government will be able to appoint another auditor.

Its consequences are:

- The auditor who is removed by the Tribunal cannot be appointed as an auditor of that company for 5 years.
- Punishment with imprisonment for 6 months to 10 years and with a fine of an amount involved in the fraud which may extend to 3 times the said amount.
- For fraud involving public interest the minimum period of imprisonment will be three years.

2. Penalty for Non-filing of Statement with ROC after Resignation

The auditor who has resigned from the company shall file within a period of 30 days from the date of resignation, a statement in the prescribed form with the company and ROC stating the reasons and other facts as may be relevant with regard to his resignation in form ADT – 3.

If the auditor does not comply with these requirements, he shall be punishable with a fine of Rs. 50,000 – 5,00,000.

3. Penalty for Non-compliance with the Requirements of Section 139, 143, 144 and 145

Penalty for non-compliance with any of the provisions contained in section 139, 143, 144 and 145 of the Act.

Section 139 provides for appointment of auditors, section 143 deals with power and duties of auditors, section 144 is on certain services which an auditor cannot render and section 145 is on signing of audit report and other documents by auditor. Auditor shall be punishable with fine of Rs. 25000 – 500,000.

4. Penalty for Intention to Deceive Stakeholders of the Company

If an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punishable with imprisonment for a period of one year and with a fine of Rs. 1,00,000 – Rs. 25,00,000.

5. Penalty for Loss Arising out of Misleading Statements

Convicted auditor shall refund the remuneration received by him from the company and pay for damages to the company, bodies or authorities or to any other persons for loss arising out of misleading statements of particulars made in his report.

6. Penalty for Failure to Disclose Fraud

As per section 143(12), if in the course of performance of his duties as auditor, he has reason to believe that an offence involving fraud is being committed against the company by officers or employees of the company, auditor shall immediately report the matter to the Central Government. In case of any failure on his part to comply with this duty, he shall be punishable with a fine of Rs. 1,00,000 – Rs. 25,00,000.

7. Penalty Leviable by NFRA for Professional Misconduct

Where professional or other misconduct is proved against the auditor, NFRA shall have the power to make order for

(i) Imposing penalty of Rs. 100,000 to five times of the fees received in case if individuals and not less than Rs. 10,00,000 to ten times of the fees received in case of firms.

iii) Debarring the member or firm from engaging himself or itself from practice as member of the Institute of Chartered Accountant of India for a minimum period 6 months to 10 years as may be decided by NFRA.

8. Disqualification for Appointment as Auditor

A person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction shall be disqualified to be appointed as auditor of any comapny.

9. Action under Section 447

Any person who is found to be guilty or fraud, shall be punishable with imprisonment for a term of 6 months to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to 3 times the amount involved in the fraud.

10. Liability of Firm

Where in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the firm have acted in a fraudulent manner or abetted or colluded in any fraud by, or in to or by, the comapny 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 at shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

11. Class Action Suits

Any 100 or more members or deposit holders of the company or 10 per cent of the total number of members or deposit holders of the company can file a class action suit to claim damages or compensation or demand any other suitable action aginst the auditor in the manner prescribed under section 245 of the Act.

Action under this section can be initiated against the auditor including audit firm of the company for any improper or misleading statement of particulars made in the audit report or for any fraudulent, unlawful or wrongful act or conduct.

Thus, the Companies Act, 2013 has brough out the penal provisions and the actions initiated against erring auditors.

Audit of Share Capital

Procedures involved in audit of share capital may be discussed under two heads:

1. Audit of shares issued for cash
2. Audit of shares issued for consideration other than cash

Audit of Shares Issued for Cash

The audit of shares issued for cash may be divided into three stages application, *allotment* and *call*. The process of raising initial capital may be divided into two stages, *receiving application for shares* and *allotment of shares.*

Application Stage

At the application stage, application money is received along with application. The auditor should:

(i) Check the original application sent by the investors and vouch the entries with application and allotment sheets.

(ii) Vouch the amount received on applications with cash or bank book and application allotment register.

(iii) Also check the bank reconciliation statement in this regard.

(iv) Vouch repayment of application money with the application and allotment sheets and verify with the bank book.

(v) Check the total columns of application and allotment register and see that proper journal entries have been passed in the books.

(vi) Verify that the issue is within the limits as authorised by the memorandum and articles of association of the company.

(vii) Ensure that the application moneys received were deposited in a scheduled bank until the certificate of commencement of business is obtained or application money returned as per provisions of section 69(5).

(viii) See whether the amount received on application is not less than five per cent of the nominal value of shares issued.

Allotment Stage

At the allotment stage, the auditor should

(i) Examine the directors' minutes to see that all the allotments have been approved by the Board.

(ii) Compare copies of letters of allotment with entries made in the application and allotment registers.

(iii) Check the moneys received on allotment by comparing the entries in the application and allotment registers with cash book and bank statement.

(iv) Check the postings made as to the amount received on application and allotment in the share register.

(v) See that relevant requirements of RBI and Foreign Exchange Management Act, 1999 in case of allotment to non-residents.

(vi) Check whether the returns of allotment have been filed with the Registrar of Companies.

(vii) See that the provisions of section 70 are complied with in relation to allotment of shares. A valid allotment must be made in accordance with provisions of Companies Act. 2013 and the Indian Contract Act. 1972.

Call Stage

The auditor at the call stage should

(i) Examine the board of directors resolution for making calls.

(ii) Examine the total amount due on calls and compare with the amount collected and entered into cash book or bank book.

(iii) Trace out the figures of calls-in-arrears and vouch the entries made in this regard.

(iv) See that calls received in advance are duly accounted for.

(v) Verify the amount received with the counterfoils of receipts.

(vi) Verify the journal entries passed in respect of calls made and money received thereon. Besides the above. the auditor should perform the following duties also.

(i) The auditor should verify that proper entries passed for premium on shares if any.

(ii) The auditor should check the amount of forfeiture of shares and corresponding entries in this regard.

(iii) If issues were underwritten. underwriting agreement should be examined.

(iv) The auditor should vouch the payment of commission and brokerage to the underwriter.

...of Shares Issued for Consideration Other than Cash

...ares may be allotted for consideration other than cash. Vendors, promoters, ...writers etc., may be allotted shares instead of making payments to them. ...ditor in this regard should verify the following documents.

(i) Minutes of board of directors to ensure that the allotment is authorised by the Board.

(ii) Copy of the contract entered into with vendors, promoters, underwriters etc., to ensure that the allotment is made as per the agreements.

(iii) Articles of association to ensure that articles authorise allotment of shares for consideration.

(iv) Prospectus to ensure that conditions laid down therein are complied with.

(v) Return filed with the Registrar of Companies to ensure that return is filed in time regarding allotment.

(vi) Share capital account as shown in the ledger to ascertain that share allotments are posted in the ledger accounts.

(vii) Balance sheet to ensure that shares allotted for consideration other than cash are properly disclosed.

The auditor should ensure that an amount equal to the amount of premium ...been transferred to the share premium account where shares were issued at ...mium for consideration other than cash.

...dit of Shares Issued at a Premium

If shares are issued at a price higher than their face value, the excess amount ...lled premium. Audit procedures in this regard require the auditor to

(i) See that a sum equal to the aggregate amount of premium on those shares has been transferred to the share premium account (sec.78).

(ii) Ensure that the amount of premium should be utilised only for

- Issuing fully paid bonus shares to the members of the company
- Writing off the preliminary expenses or the commission paid or discount allowed on any issue of shares or debentures of the company.
- Providing for the premium payable on the redemption of any redeemable preference shares of the company.

(iii) Vouch the amount of premium so received.

(iv) Study the articles of association and minutes of the board to verify whether the issue of shares at premium had been authorised properly.

(v) See that SEBI guidelines are duly complied with.

Audit of Shares Issued at a Discount

Section 79 of the Companies Act, 1956 permits issue of shares at a discount on the following conditions.

(i) First issue of shares cannot be at discount. A class of shares already issued can be issued at a discount.

(ii) The issue is authorised by a resolution passed at the general meeting and sanctioned by the Company Law Board.

(iii) No such resolution shall be sanctioned if the maximum rate of discount specified in the resolution exceeds ten per cent unless the Board is of the opinion that a higher rate of discount is justified.

(iv) A gap of at least one year between the dates on which the company was entitled to commence business and the issue of shares at a discount.

(v) The prospectus relating to the issue of shares shall reveal particulars of discount allowed on the issue of shares or of so much of that discount as has not been written off at the date of issue of prospectus.

(vi) The shares shall be issued within two months from the date of sanction by the Company Law Board or within such extended time as it is deemed fit. Section 53 of Companies Act, 2013, resticts the issue of shares at discount except Sweat Equity Shares. Any share issued by a company at a discounted price shall be void.

Auditor's Duty

The auditor should ensure that all the requirements specified above have been duly complied with. In addition to this, the auditor should consider the following points.

(i) Whether the issue could be brought within the meaning of sweat equity as per section 79 A of the Companies Act, 1956 and also the provisions of section 53 of Companies, 2013.

(ii) Important terms of such issue

(iii) Where shares of the company are listed on the stock exchange, he should verify that the issue complies with SEBI rules.

If shares are unlisted, the auditor should ensure that the guidelines issued by the Central Government have been observed.

Audit of Issue of Bonus Shares

A company may capitalise its undistributed profits or reserves by issuing fully paid bonus shares. While auditing the bonus shares, the auditor should:

(i) Ensure that the articles of association allow capitalisation of profits of the company.

(ii) Verify the source from which bonus shares have been issued.

Premium received on issue of shares, undistributed profits, accumulated reserves and capital redemption can be used for issue of bonus shares. Bonus shares cannot be issued out of revaluation reserve.

(i) Make sure that the company had adequate number of unissued shares for allotment of bonus shares.

(ii) Inspect the resolution passed by the board of directors and ensure that shareholders have approved the issue of bonus shares. Also minute books of directors and shareholders should be verified.

(iii) Check the allotment book, share register, returns filed with the Registrar, etc.

(iv) See that proper journal entries have been passed in the books of account in this respect.

(v) Ensure that SEBI guidelines on issue of bonus shares have been duly complied with.

(vi) See that the provisions of Companies Act, 2013 are duly complied with: Free reserves should not include any change in carrying amount of an asset or liability recognised in equity, bonus shares may be issued out of such free reserves, security premium account or capital redemption reserve account.

...-back of Shares by the Company

...der section 77 A, a company may purchase its own shares or other specified ...ties out of :

(i) free reserves

(ii) share premium account

(iii) proceeds of any shares or other specified securities.

...mpany shall purchase its own shares or other specified securities unless

(a) the buy-back is authorised by the articles

(b) a special resolution has been passed in a general meeting of the company, authorising the buy-back

(c) the buy-back is less than twenty-five per cent of the paid up capital and free reserves of the company

(d) the debt – equity ratio of the company is not more than 2 per cent after such buy-back. Debt for this purpose includes all unsecured and secured debts.

(e) all the shares or other specified securities are fully paid.

(f) the buy-back of listed shares or other specified securities are in accordance with SEBI regulations.

(g) the buy-back of non-listed shares or other specified securities are in accordance with the guidelines issued by the Central Government.

Auditor's Duty in respect of Buy-back

The audit procedures of buy-back of shares require the auditor to:

(i) Check whether the articles of association of the company authorise the buy-back.

(ii) Check the minutes of directors and the special resolution passed in the general meeting of the company.

(iii) Verify that the buy-back is out of free reserves, share premium account, or the proceeds of any shares or other specified securities as provided in the Act.

(iv) Verify that the debt-equity ratio is within the limit prescribed in the Act.

(v) Inspect the necessary documents including declaration of solvency which have been filed prior to the commencement of buy-back.

(vi) Ensure that the buy-back is completed within one year from the date of passing resolution.

(vii) Ensure that the company extinguishes and physically destroys the shares bought back within 7 days from completion of buy-back.

(viii) In case of listed shares, ensure that SEBI guidelines have been followed properly.

(ix) Verify that proper entries have been passed immediately after the buy-back.

Calls Paid in Advance

A company may accept from any member the whole or any part of the amount remaining unpaid on any shares held by him as calls-in-advance. Interest at the rate of 6% or at an agreed rate is payable on the amount of calls-in- advance.

As per *Re Wake-field-Rolling Stock Co.* (1892) case, in case of winding up of the company calls in advance should be repaid along with interest before any part of the share capital is returned to shareholders.

Audit Procedure for Calls-in-Advance

The auditor shall

(i) See whether the articles of association authorise the acceptance of calls-in-advance.

(ii) Vouch the amount of calls-in-advance with the entries in books of account and share register.

(i) See that they have been shown separately in the balance sheet and not as the part of the capital.

(ii) Check that members concerned are paid interest on calls-in-advance at the rates specified in the articles.

...in Arrears

The balance of unpaid amount of calls is known as calls-in-arrears. While ...ing calls-in-arrears, the auditor should:

(i) Verify the directors' minute book to ensure that the resolution specifies the time and place of payment of calls.

(ii) Ensure that calls were made on the dates specified on an uniform basis in respect of all shares falling under the same class.

(iii) Verify the amount of calls-in-arrears from the share register.

(iv) Verify whether articles provide for charging interest on the amount of calls-in-arrears.

(v) Ensure that calls-in-arrears amount is shown on the liability side of the balance sheet. It should be deducted from the amount of called up capital.

(vi) See that the amount of calls due from directors of the company has been shown separately in the balance sheet.

...feiture of Shares

If any shareholder fails to pay the call money, the shares held by him may be ...feited by the company.

While auditing the forfeiture of shares, the auditor should:

(i) Verify whether the articles of the company permit the forfeiture of shares.

(ii) See that the board of directors also authorise the forfeiture and the forfeiture has been done in the best interest of the company.

(iii) See that the resolution for the issuance of share capital and forfeiture of shares has been duly passed.

(iv) Verify the amount of calls which was outstanding with respect to share forfeiture.

(v) Ensure that the defaulting shareholders have been served with sufficient notice intimating the amount due from them and the decision of the company to forfeit their shares.

(vi) Verify that proper entries were passed in the books of account and ensure that any premium received on forfeited shares would be transferred to share premium account.

Re-issue of Forfeited Shares

Forfeited shares may be reissued. It may be at any price provided that the total sum paid by the former holder, together with the amount paid on reissue is not less than the face value. Otherwise, it would be treated as shares reissued at discount.

While auditing reissue of forfeited shares, the auditor should:

(i) Ascertain whether the board of directors is authorised to reissue the forfeited shares under the articles of association of the company.

(ii) Inspect the board's resolution for forfeiture and reissue of forfeited shares.

(iii) See that the total amount collected on reissue along with forfeited sum is not less than the par value of shares.

(iv) See that any surplus amount after the reissue of forfeited shares has been transferred to capital reserve account.

(v) Ensure that proper entries were recorded in the books of account relating to share forfeiture.

Alteration of Share Capital

A company may alter its share capital without the consent of the court. Proper authorisation in the articles and an ordinary resolution are required for this purpose. Alteration of share capital may result in:

(i) Increase in share capital

(ii) Consolidation and division of all or any of its share capital into shares of higher denomination.

(iii) Conversion of fully paid up shares into stock or vice versa

(iv) Shares of smaller amount

(v) Cancellation of unissued shares and diminishing the amount of share capital by the amount of shares so cancelled.

Effect of Alteration of Share Capital

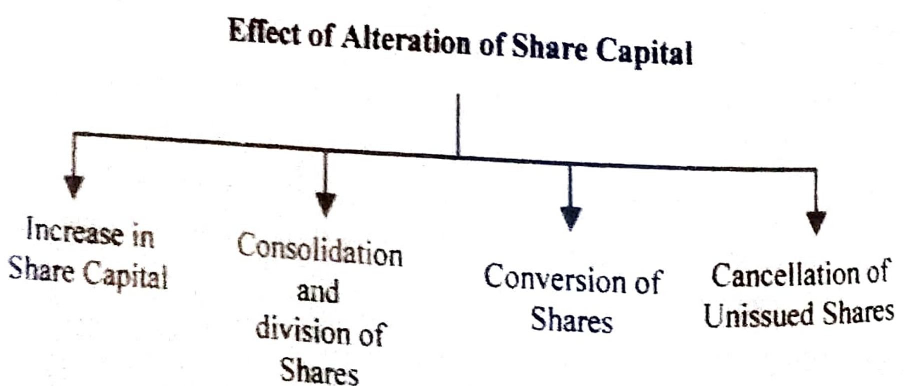

Figure 18.1 - Alteration of share capital

Procedure for Alteration of Share Capital

...e auditor should:

(i) Verify that the alteration of share capital has been duly authorised by the articles of the company and by the general meeting.

(ii) See that the alteration is duly resolved by the board of directors

(iii) See that all the procedures have been complied with including the information to be furnished to the Registrar of Companies regarding alteration.

(iv) Obtain lists of allotment of shares including the new holding or shares or stocks of each member and verify the same with the entries recorded in the books of account.

(v) Examine the cancelled certificates if any, and verify with the counterfoils of new share certificates issued in this behalf.

(vi) Ensure that the amount of share capital is correctly shown in the balance sheet of the company.

(vii) Ensure that the alteration carried out has been noted in every copy of the memorandum and articles issued after the date of such alteration.

(viii) Confirm that necessary changes and alterations have been informed to the Registrar of Companies.

...uction of Share Capital

A company may reduce its share capital if so authorised by articles by a ...al resolution and subject to confirmation by the court.

...ction of Share Capital includes the following:

(i) Reducing the liability on any of the unpaid shares

(ii) Cancelling the share capital which is not represented by the assets

(iii) Paying off excess share capital which is not required by the company.

...itor's Duty

The auditor should:

(i) Examine the articles and confirm that articles authorise reduction of share capital or a special resolution was passed to alter the articles to that effect.

(ii) Verify the minutes of shareholders and ensure that necessary special resolution has been passed in this respect.

(iii) Examine the order of the court which permits the company to carry out reduction of share capital.

(iv) Ensure that the copies of the court and minutes of shareholders have been filed with the Registrar of Companies.

(v) Verify the certificate of reduction of share capital by the Registrar.

(vi) Ensure that proper journal entries have been recorded to give effect to the reduction of share capital and see that the writing down of the assets is in conformity with the resolution passed in the shareholders' meeting and other supporting documentary evidence.

(vii) Ensure that the revaluation of assets have been properly disclosed in the balance sheet.

(viii) Verify the adjustments made on account of reduction of share capital with the register of members.

(ix) Ensure that the memorandum of association is suitably altered.

Shares Transfer Audit

While auditing transfer of shares, the auditor should:

(i) Verify the adequacy of internal control system in relation to shares transfer.

(ii) Ensure that application for transfer of shares has been made in the prescribed form, stamped by the prescribed authority with the date of its presentation.

(iii) Ascertain whether notices were sent to the transferor. Objection if any raised by the holder must be considered before registering transfer.

(iv) Verify the signatures of the transferor from their specimen signatures on the original application forms or previous transfer deeds.

(v) In case of joint holding, ensure whether all have signed in the transfer deed.

(vi) See whether the company has created any charge on shares transferred.

(vii) Inspect the minutes of the board to verify whether all the transfers have been duly authorised.

(viii) Verify vouch entries relating to share transfer in journal proper.

(ix) Verify transfer fees collected and see that they have been transferred to profit and loss account.

(x) See that transferor's certificate is duly cancelled so that it may not be presented in support of another transfer.

(xi) In case of transfer for only a part of holding, ensure that a fresh share certificate has been issued to the transferor stating the balance of shares held by him.

(xii) Confirm that due notices were given to transferor and transferee within two months where transfers had been refused.

(xiii) Verify that a bond of indemnity has been obtained from the shareholder for issuing duplicate certificate to them.

Transmission of Shares

On the death, insolvency or lunacy of a shareholder his shares are transferred to his legal representative by operation of law. This is termed as transmission of shares. While transfer of shares is a voluntary act, transmission of shares takes place by operation of law.

As regards transmission of shares, the auditor should:

(i) Ensure that the company has strictly followed the relevant procedures prescribed by the articles.

(ii) Verify the grant of probate or succession certificate

(iii) In the event of insolvency, examine the following

- the succession certificate granted by the court
- the certificate issued by the Controller of Estate Duty to confirm that estate duty has been paid thereon.
- request from the executor or legal representative that shares be entered in his name.
- order of the court

(iv) Examine the minutes of board of directors relating to transmission of shares.

(v) Verify whether the company has sent notices to the transferee and transferor where the request for transmission of shares has been refused.

(vi) Verify whether the transfer fees collected and total number of shares transferred during the period are reconciled and duly accounted for.

Issue and Redemption of Preference Shares.

In case of issue of preference shares, the auditor should:

(i) Verify whether the articles empower the company to issue redeemable reference shares.

(ii) Examine the minutes of the board for verifying matters relating to issue, allotment and calls.

(iii) Vouch the amount collected on issue of redeemable preference shares with the relevant documentary evidence.

(iv) See that the balance sheet contains details as to terms and conditions of redemption or conversion together with the date of redemption or conversion.

In relation to redemption of preference shares, the auditor should:

(i) Verify the articles of association of the company authorising redemption.

(ii) Verify whether the company has complied with the provisions of the said section.

Chapter 19

Audit of Dividends and Debentures

A joint stock company is promoted with a profit motive. Prospective investors invest their funds in the shares and debentures of a company. The return on their investment is given in the form of dividend.

Meaning and Definition of Dividend

The expression dividend originated from the Latin word "dividendum" meaning that which is to be divided. In the Company Law and Practice, dividend means that portion of the profit which can be distributed amongst the shareholders.

A few definitions of dividend are given.

1. The dividend is that portion of the corporate profits which has been set aside and declared by the shareholders.

   Bacha F.Guzdar Vs CIT

2. "Profits available for dividend" means net profit after making any deduction which the directors can duly make.

   Fisher Vs Black and White Publishing Co. (1901)

3. Dividend means the sum paid and received as the quotient, forming the share of the divisible sum payable to the recipient.

   Hanuman Prasds Vs. Hiralal

Provisions of the Companies Act, or Rules for Dividends

Dividend shall be declared and paid according to the Provisions of Companies Act;

Rules regarding Declaration of Dividend

1. Resolution at the annual general meeting

(a) Final Dividend is generally declared at an annual general meeting at a rate not more than what was recommended by the directors, in accordance with the articles of association of a company.

(b) Board of directors must state in the *Directors' Report* the amount of dividend, which it recommends to be paid. This is called the *final dividend,* whereas the interim dividend, is simply paid after the Board resolves to pay it. This does not require approval of the shareholders.

(c) The dividend recommended by the Board of directors in the *Board's Report* must be declared at the annual general meeting of the company. This constitutes an item of ordinary business to be transacted at every annual general meeting. This does not apply to interim dividend.

2. Payment of dividend in proportion to paid-up capital

According to Section 51 of the Companies Act, 2013, the companies are permitted to pay dividends proportionately, *i.e.*, in proportion to the amount paid on each share when all shares are not uniformally paid up, *i.e.*, on *pro rata* baisis. *Pro rata* means in proportion or proportionately, according to a certain rate. The Board of Directors of a company may decide to pay dividends on pro rata basis, if all the equity shares of the comapny are not equally paid-up. However, in the case of preference shares, dividend is always paid at a fixed rate. [Table F, Article 83 (iii)]

3. Dividend to be paid only out of profits

Dividend can be declared or paid by a company for any financial year,

(a) Out of the profit of the company for that year arrived at after providing for depreciation in accordance with Schedule 11 of the Companies Act, 2013.

(b) Out of profit of the company for any previous financial year/years arrived at after providing for depreciation in accordance with the provisions of the Act and remaining undistributed, out of both [Section 123(1)(a)] or

(c) Out of both or out of moneys provided by the central Government or a State Governement for payment of dividend in purauance of a guarantee given by the concerned Government [Section 123(1)(b)].

4. Establishment of Investor Education and Protection Fund

According to section 125 of the Companies Act, 2013 as introduced by the Companies (Amendment) Act, 1999, the Central Government shall estblish a fund to be called the Investor Education and Protection Fund.

5. Compulsory transfer to the reserves up to 10 per cent of profits

Dividend can be declared by a company for any financial year only after the transfer to the reserves of the company of such percentage of its profits for that year, not exceeding ten per cent as prescribed by the Central Gevernment.

6. Dividend payable only in cash

The dividend is payable only in cash. Dividend has to be paid within 42 days from the date of declaration. But the capitalization of profits or reserves of the company for the purpose of issuing fully paid bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company is not prohibited.

7. Compliance with provisions of Section 55

A company which fails to comply with the provisions of Section 55, i.e., where it fails to redeem preference shares as required by Section 55, cannot declare dividend on its equity shares.

8. Dividend to be paid out of current year's profit only

The dividend can be paid out of current year's profits. In the event of inadequancy of profits in any year, the company can declare dividend out of the accumulated profits only in accordance with the rules to be framed by the Central Government.

9. Unpaid dividend to be transferred to special divided account

If dividend has not been paid or claimed within the said 42 days, the company is required to transfer the total amount of dividend which remains unpaid or unclaimed, to a special account to be opened by the company in a scheduled bank to be called, "Unpaid Dividend Account of ...... Company Limited/Private Limited". Such transfer shall be made within 7 days from the date of expiry of the said 30 days.

10. Transfer to Investor Education and Protection Fund

Any money transferred to the *Unpaid Dividend Account* of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the Investor Education and Protection Fund, established under Section 125 [section 124(5)].

11. Statement of the nature of sums and the persons entitled to them to be furnished

When the company makes any transfer to the Investor Education and Protection Fund, established under Section 125 of any unapid or unclaimed dividend, it shall furnish to the authority or committee appointed by the Central Governement a statement furnishing-

(a) The nature of the sums,

(b) The names and the last known addresses of the persons entitled to receive the sum,

(c) The amount to which each person is entitled, and

(d) The nature of his claim thereto and such other particulars as may be prescribed.

12. Receipt

The company shall be entitled to a receipt from the authority or committee established under Section 125 for any moany transferred by it to the Investor

Education and Prorection Fund. Such a receipt shall be an effectual discharge of the company in respect thereof.

13. Dividend in the event of inadequacy or absence of profits

If owing to inadequacy or absence of profits in any year, a company proposes to declare dividend out of the accumulated profits earned by it in any previous financial year or years and transferred to reserves, such declaration of dividend shall be made as per the provisions of Section 123(a).

14. Payment of unpaid or uncliamed dividend

Any person claiming to be entitled to any money transferred to the Investor Education and Protection Fund may apply to the authority or the committee appointed under the fund, for the refund of money due to him. If the authority or committee is satisfied that such person is entitled to the whole or any part of the money claimed, it shall make an order for the payment after taking the necessary security from him.

15. Dividend to be paid to the registered shareholder

No dividend shall be paid by a comapny in respect of any shares except to the registered holders of such shares or to his order or to his banker. In the case of a share warrant, payment should be made to the bearer of the warrant or to his banker.

16. Right to dividend, rights shares and bonus to be held in abeyance pending registration of transfer of shares

In case of listed companies, Section 24 confers on SEBI, the power of administriation of the provisions pertaining to non-payment of dividend. SEBI can exercise the powers only under Section 126 *i.e.*, 'Right to dividend, rights shares, and bonus shares to be held in abeyance pending registration of transfer of shares', and under Section 127 *i.e.*, penalty for failure to distribute dividends within 30 days. All other powers remain vested in Central Government.

17. Penalty for defaulting directors

After the dividend has been declared by a company, it shall be paid within 42 days from the date of declaration of the dividend to every shareholder entitled to payment of dividend. If this is not done, every director, who is knowingly a party to the default, is punishable with simple imprisonment upto 7 days and with fine.

Judicial Rulings on Dividends

1. ***Lubbock Vs. The British Bank of South America Ltd (1892)***

Held "that if a company's articles of association so provide a profit made on the sale of a part of the undertaking could be distributed as dividend".

2. *Foster Vs. The New Trinidad Lake Asphalte Co. Ltd (1900)*

Held that a realised appreciation in the value of one item of capital assets cannot be deemed to be profit divisible among the shareholders until and unless such of surplus remains after revaluation of whole of the assets and liabilities.

3. *Bolton Vs. Natal Land and Colonisation Co.Ltd (1891)*

Held that a company may declare a dividend out of current profits without being obliged making good loss of capital.

4. *Verner Vs. The General and Commercial Investment Trust Ltd (1894)*

Held that a company cannot be restrained from paying a dividend out of current profits on the ground that the capital of the company is not intact, if the company is solvent and acting within its articles.

Interim Dividend Vs. Final Dividend

Final Dividend	Interim Dividend
1. A dividend is declared generally once in a year (*i.e*) in annual general meeting.	1. Interim dividend is usually declared in between two annual general meetings.
2. Shareholders in the annual general meeting declare a final dividend.	2. The board of directors declares an interim dividend.
3. A final dividend can be declared only after the accounts are prepared and the profit is ascertained.	3. An interim dividend is declared before the preparation of final accounts.
4. There not be any express provision in the articles for declaring a final dividend.	4. Board of Directors can declare interim dividend only when the articles expressly permit a declaration.
5. A final dividend once declared shall become a debt due from the company.	5. An interim dividend once declared shall not become a debt due from the company to shareholders.
6. Once declared, shareholders cannot cancel the declaration of final dividend.	6. Directors are empowered to cancel the declaration of interim dividend after it is declared.

Auditor's Duty with regard to Payment of Dividend

In case of audit of payment of dividend, the auditor should:

(i) Ensure that the company has followed the relevant provisions of the Companies Act, 2013.

(ii) See that the dividend paid is in accordance with the rights attached to the stock or share capital by examining the memorandum and articles of the company.

(iii) Ascertain that profits of the company permitted the dividends to be paid.

(iv) Inspect the minutes of directors as well as shareholders authorising the payment of dividend and also verify the rate of dividend.

(v) See that the resolution for recommending the declaration of dividend has been passed.

(vi) Verify whether dividend declared by the company has been paid within the prescribed time period.

(vii) Examine the dividend register showing the dates of dispatch of cheques or dividend warrants to shareholders.

(viii) Vouch the payment of dividend from the entries made in the dividend account, profit and loss appropriation account, the cash book and shareholders' receipts.

(ix) See that the unclaimed dividend are shown in the balance sheet of the company under current liabilities.

(x) Ascertain the transfer of the total amount of the dividend from the general bank account to the dividend bank account.

(xi) Check the net dividend column in the dividend book with the returned endorsed warrants.

(xii) See that the figures in the dividend pass book and the total of outstanding warrants agree with the balance shown.

(xiii) Verify the balance of the dividend account by obtaining confirmation of the banker for the balance in the bank account.

(xiv) Ascertain that the amount appearing in the profit and loss account includes the dividend.

...rim Dividend and Auditor

...hile auditing interim dividends, the auditor should:

(i) Ascertain that all the assets and liabilities appear at their true value in the balance sheet.

(ii) Check that adequate contingency has been provided for losses which may arise in near future.

(iii) Ascertain whether the payment of interim dividend affects the working capital adversely.

(iv) Examine the dividend polices followed in the past in respect of interim dividend and also check the rate of interim dividend paid in the previous year.

(v) Ensure that the profits earned by the company have been carefully estimated and check the interim accounts prepared for the half year.

(vi) Carefully enquire into the conditions of trade and prospects for the remainder of the year.

(vii) Examine the cash or liquidity position of the company.

(viii) See that rate fixed has been lower than the estimated rate of final dividend.

Audit of Debentures

The term debenture is derived from the Latin word "debere" meaning "to owe". Debenture includes debenture stock, bonds or any other securities of a company, whether constituting a charge on the assets of the company or not.

Definition of Debenture

A debenture may broadly be defined as "an instrument in writing, issued by a company under its seal and acknowledging a debt for a certain sum of money and giving an undertaking to repay that sum on or after a fixed future date and meanwhile to pay interests thereon, at a certain rate per annum of stated intervals.

Related Documents to be Verified

For audit verification of debentures, the following documents are available.

- Prospectus or statement in lieu of prospectus
- Debenture application and allotment book
- Directors' minute book
- Cash book
- Debenture register
- Debenture trust deed

Auditor's Duty

While auditing debentures, the auditor should:

(i) Ensure that the company has complied with SEBI guidelines.

(ii) Inspect the debenture trust deed and ensure that the company fulfilled the conditions laid down by the trust deed.

(iii) Verify whether the prospectus has been filed before the due date.

(iv) Verify the names and addresses of the allottees and whether the allotment is authorised by the directors.

Audit Report

The final stage in the audit process is the audit report. It is the means by which the auditor formally communicates the results of his audit to the members of the company as well as to other readers of financial statements. The auditor`s report does not guarantee the truth or otherwise of the matter reported upon. It is an expression of auditor's opinion on the financial statements.

Form and Content: The AAS 28 prescribes the form and content of the auditor's report:

1. Title of the report
2. Name of the Addressee
3. Introductory paragraph
4. Scope
5. Opinion
6. Signature
7. Place of signature
8. Date of the report

1. Title of the Report

An appropriate title such as the auditor's report helps the readers identify the report. It distinguishes it from the reports that might be used by others.

The report should disclose the exact name of the client.

2. Name of the Addressee

The addressee is a person to whom the report should be forwarded. The report should be appropriately addressed as per the purposes of engagement and applicable laws. Normally, the audit report is submitted to the person who appoints the auditor. When the client is a company, the report should be addressed to the shareholders.

3. Introductory Paragraph

The financial statements can be identified from the date and period covered by the financial statements.

It states the auditor's responsibility to express opinion on financial statements audited by him.

4. Scope

The scope paragraph specifies the scope of work performed as per generally accepted auditing standards. The statement that the audit was adequately planned and performed well to ascertain the truth is also included in the scope paragraph.

5. Opinion Paragraph

The auditor's opinion on the books of account and financial statements examined by him is based on the factual information and free from bias. An auditor has to opine:

(i) Whether the financial statements are arithmetically correct and correspond to the figures recorded in the books of account.

(ii) Whether the financial statements reflect a true and fair state of affairs and the working results.

6. Signature

The auditor's report should bear the manual signature of the auditor. The auditor in his personal name should sign the auditor's report. In case a firm is appointed as auditor. the auditor will be signing in the personal name as well as in the name of the audit firm.

7. Place of signature

The report should name specific location, which is ordinarily the city where the audit report is signed.

8. Date of the Report

The report should be dated. The date of the audit report signifies the date of completion of audit work.

Requisites of a Good Audit Report

A good audit report conforms to the following criteria.

1. Based on factual information
2. Effective presentation
3. Honest disclosures
4. Unbiased Approach
5. Balanced criticism and logical suggestions
6. Clear and Unambiguous language
7. Precise, brief and complete

1. Factual Information

The audit report should consist of only factual information about the state of affairs of the company. His opion should be based on the information ascertained by him and explanations given by the management.

2. Effective Presentation

The presentation of the auditor's report should be effective and in a manner prescribed by the Act. The auditor should ensure that the report is made available to the shareholders at the general meeting.

Honest Disclosures

The report should not exaggerate or hide discrepancies in the internal control system. Weak areas in the performance of the company should be highlighted.

Unbiased Approach

An independent and unbiased approach should be followed by the auditor. He is appointed by shareholders and his duty is to prepare and present a honest and impartial report.

Balanced Criticism and Logical Suggestions

After a careful and critical evaluation of the accounting system and policies of the company, the auditor should present a report on the state of affairs of the company. The auditor is not an advisor to the management as held in *London and General Bank Case* (England, 1895). Some logical suggestions to improve the operating efficiency of the management may be put.

Clear and Unambiguous Language

The audit report is an important form of communication. The reader will be able to understand the nature of the auditor's examination. It should be written in unambiguous language.

Precise, Brief and Complete

The audit report should be brief to the point. It should have relevant material particulars. The auditor should not confine the report to the shareholders or management alone. It should cater to the interest of potential investors.

Distinction between Auditor's Report and Auditor's Certificate.

Following are the differences to note.

Auditor's report	Auditor's certificate
1. It is an expression of independent opinion on the financial affairs of a company.	1. It vouches the truth of the statement.
2. It is based on verification and examination of relevant records and documents.	2. It is a guarantee of hundred per cent accuracy of statement.
3. It does not gurantee accuracy and correctness. It states that the profit and loss account and the balance sheet exhibit a true and fair view.	3. Correctness is ascertained by verifying tangible facts.
4. The auditor will not be responsible if he presents wrong report, because it is an expression of opinion.	4. The auditor will be liable if his certificate is found wrong.
5. Suggestions as to how to improve the financial position of the company and also how to prevent frauds, etc., may be given in the report.	5. In a certificate, there is no place for such a suggestion or opinion.

Types of Audit Reports

Audit reports may be of 1) clean report 2) qualified report and 3) adverse or negative report.

Figure 22.1 - Kinds of Auditor 's Report

1. Clean Report

A clean report presents an auditor's opinion on various matters without any reservations. For example, an unqualified statement is, " in our opinion and to the best of our information and according to the explanations given to us, the balance sheet and the profit and loss account give a true and fair view of state of affairs and working results ...."

In majority of cases, auditor's reports are found to be positive, clean, or unqualified.

An auditor is not a guarantor or insurer while giving a clean chit. In Re *Kingston Cotton Mills Co. Ltd* case it was held, " auditor must not be held liable for not tracing out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by tried servants of the company".

2. Qualified Report

When an auditor gives an opinion subject to certain reservations, it is said to be a qualified report. Only when the auditor believes that the overall financial statements are not fairly stated, he can give a qualified report.

Reasons for Qualifications in Auditor's Report

(i) The auditor is unable to verify to his satisfaction the existence or the values of certain assets.

(ii) The information and explanation called for by the auditor are not furnished.

(iii) Accounts do not disclose a true and fair view.

(iv) Balance sheet and profit and loss account are not in agreement with the books of account.

(v) Provisions for bad and doubtful debts are unsatisfactory.

3. Adverse or Negative Report

When there is a reasonable ground to form an opinion that the accounts are not truly representative of the financial matters and the working results of the company, the auditor can make an adverse report.

In an adverse report, all material reasons should be disclosed.

The report may be adverse on the following grounds:

(i) The auditor is dissatisfied in material respect with regard to proper disclosure of financial information.

(ii) He is dissatisfied in material respect with regard to truth and fairness of financial statements.

(iii) Preparation and presentation of financial information is full of discrepancies and mistakes.

(iv) Financial statements do not conform to the requirements of the provisions. An opinion that the financial information does not reflect a true and fair view of the financial position and the operating results of the undertaking.

(v) There is valid evidence to form.

We give below a specimen of an audit report

Independent Auditor's Report

To the Members of Infosys Limited

Report on the Standalone Financial Statements

We have audited the accompanying standalone financial statements of Infoys Limited ('the Company'), which comprise the balance sheet as at 31 March 2015, the statement of profit and loss and the cash flow statement for the year then ended, and a summary of 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 and presentation 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 Accouting 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 the assets of the Company and for preventing and detecting frauds and other irregularities; selection and application of appropriate accounting policies; making judgements and estimates that are resonable 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 thereunder.

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 amount and the disclosures in the financial statements. The procedures selected depend on the auditor's judgement, 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, but not for the purpose of expressing an opinion on whether the Company has in place an adequate internal financial controls system over financial reporting and the operating effectiveness of such controls. An audit also includes evaluating the approriateness 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 31 March 2015 and its profit and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

1. As required by the Companies (Auditor's Report) Order, 2015 ("the Order") issued by the Central Government of India in terms of sub-section (11) of section 143 of the Act, we give in the Annexure a statement on the matters soecified in the paragraph 3 and 4 of the Order, to the extent applicable.
2. 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 purpose of our audit.
   (b) in our opinion proper books of account as required by law have been kept by the Company so far as 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 satandalone 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) on the basis of the written representations received from the directors as on 31 March 2015 taken on record by the Board of Directors, none of the directors is disqualified as on 31 March 2015 from being appointed as a director in terms of Section 164(2) of the Act; and
   (f) 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 2.20 and 2.37 to the financial statements;
      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 2.7 to the financial statements; and
      iii. There has been no delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the Company.