

---

# UNIT 1 BASIC CONCEPTS

---

## Structure

- 1.0 Objectives
- 1.1 Introduction
- 1.2 Concept of Auditing
  - 1.2.1 Origin of Auditing
  - 1.2.2 Definition of Auditing
  - 1.2.3 Difference between Accountancy and Auditing
  - 1.2.4 Difference between Auditing and Investigation
- 1.3 Objectives and Advantages of Audit
  - 1.3.1 Primary Objectives
  - 1.3.2 Secondary Objectives
  - 1.3.3 Advantages
- 1.4 Different Classes of Audit
- 1.5 Modes of Audit
  - 1.5.1 Continuous Audit
  - 1.5.2 Periodical or Final Audit
  - 1.5.3 Interim Audit
- 1.6 Qualities of an Auditor
- 1.7 Let Us Sum Up
- 1.8 Key Words
- 1.9 Answers to Check Your Progress
- 1.10 Terminal Questions

---

## 1.0 OBJECTIVES

---

After studying this unit, you should be able to :

- explain the concept of auditing
- enumerate the objectives of audit
- describe different classes of audit
- analyse various modes of conducting audit
- explain the qualities of an auditor.

---

## 1.1 INTRODUCTION

---

With the advent of large scale production verification and examination of accounting became inevitable. Auditing is the systematic and scientific examination of the books of accounts and records of a business. In this unit you will learn the concept of auditing and different classes of audit. You will also learn various modes of audit and qualities of an auditor.

---

## 1.2 CONCEPT OF AUDITING

---

The practice of auditing the accounts of public institutions existed as early as the times of ancient Egyptians, the Greeks and Romans. In those days checking clerks were appointed to scrutinise the accounts of public institutions. The main purpose of auditing during those days was to ascertain whether the persons responsible for, maintaining accounts had properly accounted for all receipts and payments or not, and to locate frauds.

### 1.2.1 Origin of Auditing

Audit, as it exists today, is the result of Industrial Revolution in 18th century, which brought in its wake large scale production, steam power, improved banking facilities and

better means of transport and communication. The Revolution also resulted in the increase of trading and industrial operations which required huge amounts of capital. It was not possible for small entrepreneurs to meet the requirements of increased capital due to their limited resources. This gave birth to joint stock form of organisation. Under this form of organisation, the shareholders contribute capital and have no control over the day-to-day working of the organisation. The shareholders who have invested their money would naturally be interested to know the financial position of the organisation. As such, the need arose for appointing an independent person who would check the accounts and report to the shareholders on the accuracy of the accounts and the safety of their investment.

The system of accounting and auditing of state revenue and expenditure is believed to have existed in India under Maurya and Hindu Kings. Kautilya in his *Arthashastra* had given details regarding accounting and auditing of state finances. According to him, "all undertakings depend on finance. Hence, foremost attention shall be paid to the treasury." He had also mentioned various frauds and embezzlements and prescribed punishments for the same.

The growth of accounting profession in India is of recent origin. For the first time, Indian Companies Act, 1913 prescribed the qualifications of an auditor and also mentioned his powers and duties and the procedure of appointment. According to this Act, the audit of Joint Stock Company was made compulsory. The diplomas and certificates were issued by the Central and State Governments to those who had undergone the prescribed an Indian Accountancy Board to advise on matters relating to professional accounting. In the year 1949, the Chartered Accountants Act was passed according to which the affairs of the profession were passed on to the profession itself i.e., Institute of Chartered Accountants of India. Further, the Companies Act, 1956 elaborated the provisions relating to the accounts and audit of Companies. Now, a person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949.

### 1.2.2 Definition of Auditing

The word 'audit' is derived from the Latin word 'audire' which means 'to hear'. In the olden days whenever the proprietors of a business concern suspected fraud, they appointed a person to check the accounts and to hear the explanations given by the persons responsible for keeping the accounts. The audit during those days was interested in ascertaining whether the persons responsible for maintaining amounts had properly accounted for all receipts and payments to his principal and to locate frauds and errors. It was merely a cash audit. However, the object of the modern audit is not confined to cash verification but to report on financial position of the undertaking as disclosed by its Balance Sheet and the Profit and Loss Account.

It is very difficult to give a precise definition of the term 'auditing'. Some of the definitions given by different writers are as follows :

According to Montgomery, a celebrated author, "auditing is a systematic examination of the books and records of a business or the organisation in order to ascertain or verify and to report upon the facts regarding the financial operation and the result thereof."

The above definition has been expanded further by Spicer and Pegler as follows :

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

According to Lawrence R. Dicksee, "an audit is an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some instances, it may be necessary to ascertain whether the transactions themselves are supported by authority."

R.K. Mautz defines auditing as being "concerned with the verification of accounting data, with determining the accuracy and reliability accounting statement and reports."

From the above definitions, it is clear that *auditing is the systematic and scientific examination of the books of a accounts and records of a business so-as to enable the auditor to satisfy himself that the Balance Sheet and the Profit and Loss Account are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.* In order to report on the financial health of the business, the auditor will have to go through various books of accounts and related evidence (external and internal) to satisfy himself about their accuracy and authenticity.

### 1.2.3 Difference between Accountancy and Auditing

- 1 Accountancy is mainly concerned with the checking of the transactions recorded in the books of accounts, extraction of the trial balance, preparation of the trading, profit and loss account and balance sheet. Auditing is the critical examination of the books of accounts and checking of the financial statement for the purpose of ascertaining the true and fair position and results of operation of a concern. Audit does not involve the preparation of accounts but it is concerned with the detailed examination of the complete accounting records.
- 2 Some times, auditor is called upon to write up the books of accounts, extract an agreed trial balance and prepare Profit and Loss Account and Balance Sheet. If he does that, he would be doing the work of an **accountant** and not that of an **auditor**. Thus, the preparation of the accounts is not part of an audit. As an auditor he is required to report, to his appointing authority, that the Profit and Loss Account and the Balance Sheet have been properly drawn up and reveal the 'true and fair view' of the state of affairs and results of operation of the concern.
- 3 An auditor starts his work only after the job of an accountant is completed. In other words, there cannot be auditing without the prior existence of accounts.

### 1.2.4 Difference between Auditing and Investigation

- 1 Investigation is the examination of accounts for a special purpose. The purpose may be to find out the financial position of the borrowing concern or the earning capacity of the concern, etc., whereas audit is carried out to ascertain whether or not the Profit and Loss Account and the Balance Sheet exhibit a true and fair view of the state of affairs and results of operation of the undertaking.
- 2 An audit is performed on behalf of the owners of the organisation whereas the investigation may be carried out on behalf of an outsider who intends to join the business as a partner or on behalf of the proprietors when they suspect fraud in their business.
- 3 An audit relates to 6 months or one year period but investigation may concern 2, 3, and 4 years etc.
- 4 Investigation is not compulsory whereas Audit is compulsory in case of Joint Stock Company.
- 5 The programme of work investigation depends upon the purpose of an investigation. It is not confined to the examination of accounts but enquiry into the relevant matters also. But auditing is concerned with the critical examination of the accounting records and report on the financial state of affairs, and results of operation of a concern for a particular financial year.

#### Check Your Progress A

- 1 Define Auditing.

.....  
 .....  
 .....

- 2 Distinguish between accountancy and auditing.  
.....  
.....  
.....
- 3 State whether the following statements are True or False.
  - i) Auditing of accounts is compulsory in a partnership firm.
  - ii) Auditing of accounts is undertaken to detect frauds in the books of accounts.
  - iii) A professional auditor cannot take up the work of preparing the accounts of a company.
  - iv) Investigation is taken up only behalf of the owner of the entity.
  - v) Investigation of accounts is not compulsory but audit of accounts is, in case of accountant.
  - vi) Accounts of an individual concern should be audited by the qualified professional accountant.
  - vii) In ancient period the audit was confined to cash audit and not to locate frauds.
  - viii) Audit of company accounts is compulsory under the Institute of Chartered Accountants Act of 1949.

**1.3 OBJECTIVES AND ADVANTAGES OF AUDIT**

The objectives of an audit may broadly be classified as (1) Primary objectives and (2) Secondary objectives. Let us discuss them in details.

**1.3.1 Primary Objectives**

The main purpose of audit is to determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period. The Companies Act, 1956 requires that the auditor of a Company has to state whether in his opinion the accounts disclose a 'true and fair view' of the state of company's affairs, profit and Loss Account and Balance Sheet of the state of affairs of a business, the auditor carries out a process of examination and verification of books of accounts and relevant documents. Such an examination will enable the auditor to report to his client on the financial condition and working results of the organisation. While carrying out the examination of the various books of accounts, relevant documents and evidences, the auditor may come across certain errors and frauds. Despite such a possibility the detecting of errors and frauds is an incidental object. However, laymen have always associated the detection of errors and frauds as the main function of an auditor which is not true.

At the same time audit also discloses how far the accounting system adopted in the organisation is adequate and appropriate in recording the various transactions as well as the weaknesses of these systems.

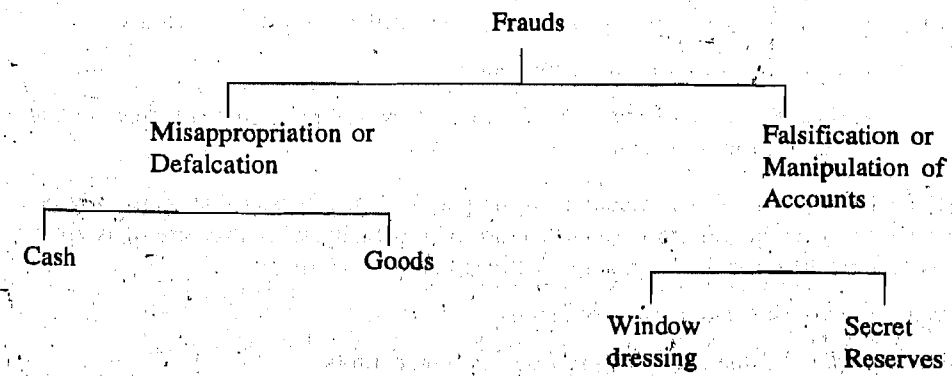
**1.3.2 Secondary Objectives**

As stated above, an auditor has to examine the books of accounts and the relevant documents in order to report on the financial condition of the business. In the process of such an investigation of accounts certain errors and frauds may be detected. These are discussed under the following two heads:

**Detection and Prevention of Errors :** Errors are of various types which are discussed below:

- 1 **Clerical Errors :** Such an error arises on account of wrong posting. For example, an amount received form R is credited to S. Though there is wrong posting still the trial balance will agree. Clerical errors are of three types as follows:
  - a) **Errors of Commission :** These errors are caused due to wrong posting either wholly or partially of the amount in the books of original entry or ledger accounts or wrong calculations, wrong totalling, wrong balancing, and wrong casting of subsidiary books. For example, Rs. 2000 is paid to a supplier and the same is recorded in the cash book. While posting to the ledger, the supplier's account is debited by Rs. 200. It may be due to carelessness of the clerk. Most of the errors of commission are reflected in the trial balance and these can be discovered by routine checking of the books.
  - b) **Errors of Omission :** Such errors arise when the transactions are not recorded in the books of original entry or posted to the ledger. For example, sales are not recorded in the sales book or omission to enter invoices in the purchase book. For example, Rs. 5,000 is paid to a supplier. The entry in the cash book is made on the credit side but posting to the supplier side is omitted. Errors due to entire omission will not affect the trial balance whereas error due to partial omission will affect the trial balance and can be detected.
  - c) **Compensating Errors :** When two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are referred to as compensating errors. For example, A's account which was to be debited for Rs. 200 was credited for Rs. 200 and similarly, B's account which was to be credited for Rs. 200 was debited for Rs. 200. These two mistakes will nullify the effect of each other. Both the sides of the trial balance are equally affected. As such, these errors are difficult to locate unless detailed investigation is undertaken.
- 2 **Errors of Principle :** Such errors are committed when some fundamental principle of accounting is not properly observed in recording a transaction. For example, if there is incorrect allocation of expenditure or receipt between capital and revenue or when closing stock is over-valued. Though trial balance will not disagree, the Profit and Loss Account may be very much affected. Sometimes, such errors are committed deliberately to falsify the accounts or unintentionally due to lack of knowledge of sound principles of accounting. Thus, a thorough examination is to be done to locate such errors.

**Detection and Prevention of Frauds :** Frauds are always committed deliberately and intentionally to defraud the proprietors of the organisation. If the frauds remain undetected, they may affect the opinion of the auditor on the financial condition and the working results of the organisation. It is, therefore, necessary that the auditor should exercise utmost care to detect such frauds. Frauds may be of the following types:



As it is clear from the above chart that frauds may be classified into misappropriation and falsification. Let us discuss them in detail.

1 **Misappropriation of cash :** Misappropriation or defalcation of cash is very common specially in a big business firm, since the owner has very little control over the receipts and payments of cash, since the owner has very little control over the receipts and payments of cash. Cash may be misappropriated by various ways as follows :

- i) Suppressing receipts
- ii) recording less amount than the actual amount of receipt
- iii) Recording fictitious payments
- iv) Recording more amount than the actual amount of payment.

In order to discover such misappropriation of cash, the auditor should check the Cash Book with original records, counterfoils or receipt book, bills register, salesmen's diary, invoices, wage sheets, vouchers, etc. There should be strict control over receipts and payments of cash known as **"Internal check system"**.

2 **Misappropriation of goods :** Misappropriation of goods is very common specially when goods are not bulky and are of high value. It is very difficult to detect such misappropriation of goods unless proper records of stock inward and outward are maintained in the organisation. Only proper accounting for purchases and sales, stock taking and periodical checking of stock can reduce the possibility of such fraud.

3 **Falsification or Manipulation of accounts :** Accounts may be manipulated by those responsible persons who are in the top management of the organisation in order to achieve certain specific objectives. The accounts are prepared in such a manner that they disclose only a distorted picture and not the true picture. Thus, the true picture of the business is concealed and a distorted picture is revealed. Manipulation of accounts may be resorted to by various means and a few may be mentioned as follows:

- i) Charging excess or less depreciation
- ii) Writing off of excess or less bad debts
- iii) Providing for excess or less doubtful debts
- iv) Over-valuation or under-valuation of closing stock
- v) Suppressing sales and purchases or showing fictitious sales and purchases
- vi) Charging capital expenditures to revenue and vice-versa
- vii) Inflating or deflating expenses and incomes, etc.

**Window dressing :** When accounts are prepared in such a way that apparently on the face of it, they indicate a much better picture than actually what they are, it is known as **"window dressing"**. The main objectives behind this are :

- i) to obtain further credit
- ii) to attract prospective partners or shareholders
- iii) to earn more commission when payable on the basis of performance
- iv) to win the confidence of shareholders
- v) to raise the price of shares in the market by paying higher dividend so that shares held may be sold.

**Secret Reserves :** When accounts are prepared in such a way that apparently on the face of it, they disclose worse picture than actually what they are, it is known as **"Secret Reserves"**. The main objectives behind this are :

- i) to avoid or reduce the tax liability
- ii) to conceal the true position from the competitors
- iii) to reduce the price of shares in the market by not paying dividend or paying lower dividend so that the shares may be bought at a much lower price.

Since these frauds are committed by those persons in the organisation who are at the helm of affairs like directors, managers, financial controllers, etc. it is really difficult to detect such frauds. Therefore, the auditor must be extraordinarily vigilant and should make searching enquiries to arrive at the true position.

### 1.3.3 Advantages

There are a number of advantages in having accounts audited even when there is not legal requirement for doing so. Some of the important advantages are given as under :

- 1 Auditing accounts carry greater authority than accounts which have not been audited.
- 2 If accounts are audited then errors and frauds can be detected and rectified in time.
- 3 A regular audit of accounts creates a scare amongst the employees of accounting department and also exercises a great moral influence on the client's staff thereby restraining them to commit frauds and errors.
- 4 Audited accounts are readily acceptable by the Revenue authorities, i.e. Income Tax, Sales Tax and land Revenue Departments, etc.
- 5 Audited accounts facilities settlement of claims on the retirement/death of a partner.
- 6 Financial institutions like Banks, LIC, HDFC, HUDCO and similar organisations consider audited accounts for processing loan applications.
- 7 In case of Joint Stock Company where ownership is divorced from management, audit of accounts ensure the shareholders that accounts have been properly maintained, funds are utilised for the right purpose and the management have not taken any undue advantage of their position.
- 8 Audited accounts help in the early settlement of claims from the insurance company in the event of loss of property by fire or on happening of the event insured against.
- 9 Disputes between the management and the labour unions, on matters of payment of bonus and higher wages can also be settled if accounts have been audited by an independent person.
- 10 Audited accounts also help in the determinations of purchase price for a business.
- 11 The admission of a new partner is facilitated if audited accounts of 2 to 3 years available for examination. The incoming partner may decide the terms and conditions for joining the partnership firm after studying the audited balance sheet.
- 12 The audit of accounts by a qualified auditor also helps the management on various matters, i.e., report on internal control system of the organisation or setting up of an internal audit department, etc.

### Check Your Progress B

- 1 List the types of clerical errors.

.....

.....

.....

.....

- 2 Distinguish between errors and frauds.  
.....  
.....  
.....
- 3 What do you mean by Window dressing.  
.....  
.....  
.....
- 4 Fill in the blanks with the appropriate word given in the bracket :
  - i) When two or more errors are committed in such a way that the result of these errors on the debits and credits is nil, they are known as ..... (errors or omission/compensating errors)
  - ii) ..... are always committed deliberately and intentionally to defraud the proprietors of the organisation. (errors/fraud)
  - iii) The main objective of ..... is to avoid or reduce the tax liability. (window dressing/secret reserves)
  - iv) To determine and judge the reliability of the financial statements and the supporting accounting records for a particular financial period is ..... of an audit. (primary objective/secondary objective)
- 5 State whether the following statements are True or False,
  - i) The main object of auditing is to detect frauds from the books of accounts.
  - ii) The allocation of amount between capital and revenue expenditure is a compensating error.
  - iii) Audited accounts are free from errors and frauds.
  - iv) The main purpose of auditing is to report on the effectiveness of the internal check system of organisation.
  - v) Compensating errors do not affect the balance sheet of the company as the trial balance does not disagree.
  - vi) An auditor is appointed to report on the financial position of the company after carrying out an analytical examination of the books of accounts, related documents and internal and external evidences.
  - vii) An auditor who compromises on important matters of accounting with the Board of Directors is known as dependent auditor.

### 1.4 DIFFERENT CLASSES OF AUDIT

There may be different classes of audit. Let us discuss them one by one.

1. **Audit under statutes : An Audit undertaken under Statute or Law is called "Statutory Audit".** Audit of accounts of Joint Stock Company is compulsory under the provisions of the Companies Act. The company audit is, therefore, statutory audit. Under such an audit, the rights, duties, procedure for appointment, qualification of auditor, etc. are laid down by the statute so that they cannot be restricted in any way by the board of directors or the shareholders of the company. Besides Joint Stock Companies incorporated under the Companies Act, audit is

compulsory under the different laws that govern them in the case of following undertakings :

- i) Banking Companies
  - ii) Insurance Companies
  - iii) Cooperative Societies
  - iv) Public and Charitable Trusts
  - v) Local Authorities and Government Undertakings.
- 2 **Audit of accounts of private firms :** The Partnership Act of 1932 does not require any audit of partnership firms. But these days most of the partnership agreements provide for audit of partnership accounts. As such, in the case of partnership firms, the auditor is not appointed under any law but by an agreement between the auditor and the partners. The rights, duties, scope of work, audit fee, etc., of the auditor are determined by the terms of contract. It is the duty of the auditor to complete his assignment in the light of the agreement and make a written report on the work completed by him.
- The auditor should pay attention to the following documents and points while conducting the audit of a partnership firm.
- i) Partnership Deed
  - ii) Nature of Business
  - iii) Borrowing powers of the partners
  - iv) Profit sharing ratio of the partners
  - v) Partnership Act, 1932.
- If the accounts of the partnership are audited by an independent auditor, the following advantages can be derived by a partnership firm :
- i) Settlement of accounts at the time of retirement death of a partner.
  - ii) Easy to raise loans from different sources, i.e., banks, financial institutions and companies.
  - iii) Settling disputes among the partners on various matters and facilitates admission of a new partner.
  - iv) Audited accounts are readily acceptable by the tax authorities for the purposes of assessment.
  - v) Early detection of errors and frauds and other general benefits flow from an audit.
- 3 **Audit of accounts of private individuals :** Audit of accounts for a sole proprietor is optional and not obligatory under any statute. It is always advisable for a sole proprietor, whose income is large and derived from various sources and the expenditure is also vast and varied, to get the accounts audited by a qualified person. The person so appointed must get clear instructions from the client regarding the nature and scope of his work, limitation, audit fee and time to complete the work. He should carry out the work with utmost care to avoid disputes later on. In addition to the advantages, common to all firms of audit, the following advantages may be derived by a sole proprietor :
- i) Audited accounts are readily accepted by the tax, authorities for the purpose of assessment.
  - ii) Audited accounts are helpful, after the death of the sole proprietor, in the preparation of estate duty accounts by the executors.
  - iii) Moral check on the staff of the client as the staff cannot dare to commit frauds.
  - iv) All incomes and expenditures can be properly accounted for.
- 4 **Audit of trust accounts :** Trusts are often created for the benefit of religious or charitable institutions. Sometimes, trusts are also created for the benefit of minors

or widows. In both these cases the underlying idea is that the money should be used for those for whom it is meant. A 'Board of Trustees' is created to look after the property or the funds left by the Testator. But these trustees may either present no accounts or present fictitious accounts thereby misappropriating the trust funds without the knowledge of the beneficiaries. To avoid such happenings, a provision is invariably made in the 'Trust Deed' for audit of accounts by a qualified auditor. The audit of accounts of trusts is good both for the trustees as well as for the beneficiaries. Once the trust accounts have been audited then no one can make unnecessary criticism against the trustees and the beneficiaries are assured of the proper utilisation of funds.

#### External and Internal Audit

An audit undertaken by an independent agency is called external audit. The auditor so appointed will carry out audit and submit his report on the financial conditions and the working results of the organisation to his appointing authority. The audit of a Joint Stock Company can be undertaken only by a qualified accountant i.e., Chartered Accountant, whereas it is not necessary for a private individual or partnership firm to get their accounts audited by a Chartered Accountant. However, it is always advisable to appoint a qualified auditor to check and report on the accounts.

Internal audit is an independent appraisal of activity within the organisation by specially assigned staff. Internal auditor is an employee of the organisation and his work, duties, rights and responsibilities regarding audit are determined by the management. He does not enjoy independent status. He has to evaluate the correctness of the accounting records, accounting system adopted in the enterprise and the internal control system followed in the organisation. It is not necessary that an internal auditor be a Chartered Accountant.

## 1.5 MODES OF AUDIT

An auditor may conduct audit on continuous, periodical or interim basis. Let us discuss them in detail:

### 1.5.1 Continuous Audit

A continuous audit is one, where the auditor's staff attends to the checking of the accounts work at appropriate intervals, say, weekly, fortnightly or monthly during an accounting period. In this system, the audit proceeds as accounting progresses. Continuous audit is followed in big organisations where numerous transactions of varied nature are to be checked and where the audited accounts must be ready immediately after the close of the financial year.

#### Advantages

- 1 It facilitates detailed and exhaustive checking of the accounting records and related documents as the auditor gets sufficient time at his disposal.
- 2 Errors and frauds are quickly detected and rectified as the auditor checks the accounts at frequent intervals.
- 3 Since the auditor pays surprise visits to his clients, it exercises moral check on the staff of the client and as such, they keep the work up-to-date and do not commit frauds.
- 4 The auditor can keep himself in constant touch with the activities of the business concern. He can give proper attention to all the relevant points necessary for efficient performance of his job.
- 5 Since audit work is carried out thoroughly throughout the year, the audited final accounts can be presented to the shareholders soon after the close of the financial year without any wastage of time.
- 6 It facilitates preparation of interim accounts when the question of declaration of interim dividend arises.

- 7 Since the audit work is uniformly spread over the year, there is no pressure of work at a particular point of time. Proper planning of audit can be made in advance and the audit staff can be kept busy throughout the year.

#### Disadvantages

- 1 Figures of the accounts already checked by the audit staff can be tampered with by the staff of the client.
- 2 Audit staff may not complete the work on each visit. As a result, they may forget to clear off the queries or to follow the work left on the last visit.
- 3 Continuous audit is not economical for small enterprises.
- 4 Accounting work of the client may be dislocated by frequent visits of the auditor and thus, lots of inconvenience may be caused to the client.
- 5 The audit staff may be required to take extensive notes in order to avoid any loose ends and alteration in figures between the two visits.

However, these limitations of continuous audit can be overcome if the auditor strictly prohibits the clients staff not to change the figures and pass journal entries to rectify the errors discovered. Special ticks and coloured pencils may be used to discover the changed figures. As far as possible the work at each visit must be completed and notes regarding the incomplete work or queries be kept in the current audit file.

### 1.5.2 Periodical or Final Audit

A periodical or final audit is one where the auditor takes up the audit work only at the close of the financial year when all the accounts are balanced and a trading and profit and loss account and the balance sheet are prepared. In the case of such an audit, the auditor visits his client only once a year and completes the entire audit work at one stretch. This form of audit is convenient and useful specially in the case of small business houses.

#### Advantages

- 1 Auditor attends to the work at a particular time and completes the whole work at one stretch.
- 2 There is no danger of the client's staff being changing the figures as the entire records remain in the possession of the auditor until the audit work is complete.
- 3 There is no dislocation in accounting work and inconvenience to the client's staff as the auditor comes only for a fixed period in a year.
- 4 Periodical audit is less expensive and as such it is specially suitable for small business houses.
- 5 There is no possibility of losing the thread of work of the auditor since the entire work is completed in one stretch.

#### Disadvantages

- 1 As the detailed checking is not possible there are greater chances of errors and frauds remaining undetected.
- 2 The presentation of audited accounts to the proprietors specially in case of Joint Stock Company is delayed and as such declaration of dividend is also delayed.
- 3 Periodical audit is not suitable in case of big business houses.

### 1.5.3 Interim Audit

It refers to an audit which is conducted for a part of the accounting year for some specific purpose, such as, declaration of an interim dividend by a Joint Stock Company. In other words, it is an audit which is conducted in between the two annual audits. This kind of audit involves a complete audit of the accounts prepared for a part of the year.

**Advantages**

- 1 Interim audit facilitates the work of final audit.
- 2 This audit is helpful when preparation of interim accounts becomes necessary for the purpose of declaration of interim dividend.
- 3 Errors and frauds can be detected more quickly.
- 4 This type of audit exercises moral check on the staff of the client since it is conducted during the course of the financial year.

**Disadvantages**

- 1 Chances of altering figures in the accounts which have already been audited cannot be ruled out.
- 2 Since the audit staff are required to make additional notes after the completion of interim audit, it puts much strain on the audit staff.
- 3 Interim audit involves additional time and work.

**1.6 QUALITIES OF AN AUDITOR**

An auditor to undertake the audit work of a Joint Stock Company must be a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Besides, the professional qualifications of an auditor should also possess the following qualities :

- 1 An auditor should have the thorough knowledge of accounts. It would be difficult for a person to check the accounts if he does not understand how accounts are prepared in different businesses.
- 2 He should be fully conversant with the various laws of the country such as Income Tax, Sales Tax, Company Law and other relevant laws.
- 3 He should possess thorough knowledge of the theory and practice of auditing.
- 4 He must be honest and possess high moral standards. He should never put his signature or certify any document unless he is satisfied. In London v/s General Bank case, Lord Justice Lindley observed "An auditor must be honest, that is, he must not certify what he does not believe to be true ...".
- 5 He should have the capability of understanding the technical details of clients' business. He should tactfully ask questions from his clients to obtain the requisite information so as to enable him to understand the technical nature of the transaction.
- 6 He should be constantly vigilant so that during his checking he should be able to detect frauds and errors and present an accurate picture of the accounts of the organisation.
- 7 He should maintain complete secrecy of the business of which he is auditing the accounts. He should not divulge any confidential information gathered during the audit.
- 8 He should carry out his duties cheerfully and conscientiously. He must have the courage of his conviction and show impartiality in his work.
- 9 The work of an auditor is mechanical in nature. He should show considerable perseverance and should not sign the report unless fully satisfied.
- 10 He should be able to write his report without ambiguity.
- 11 He should prove to be an independent person and must not compromise on important issues with his appointing authorities.
- 12 He should not approach his work with suspicion i.e., with the foregone conclusion that there is something wrong.
- 13 He should be reasonable in his attitude and must have patience to hear arguments.

- 14 He should be impartial, methodical and painstaking.
- 15 He should be courteous so that he can inculcate faith and confidence in the minds of his client's staff.

**Check Your Progress C**

- 1 Distinguish between external and internal audit.  
.....  
.....  
.....  
.....  
.....
- 2 Distinguish between continuous and periodical audit.  
.....  
.....  
.....  
.....  
.....
- 3 What do you mean by interim audit?  
.....  
.....  
.....  
.....  
.....
- 4 Fill up the blanks with appropriate word given in the bracket.
  - i) Interim audit ..... the work of final audit. (facilitates/hampers)
  - ii) ..... audit is less expensive and suitable for small business houses. (periodical audit/continuous audit)
  - iii) An audit undertaken by an independent agency is known as ..... (Internal audit/external audit)
  - iv) Audit of accounts for a ..... is optional and not obligatory under any statute. (sole proprietor/Joint Stock Company)
- 5 State whether the following statements are True or False.
  - i) Interim audit is compulsory under the Indian companies Act, 1956.
  - ii) Periodical audit is an internal audit undertaken by an independent agency.
  - iii) Periodical audit is compulsory for a Banking Organisation.
  - iv) Continuous audit helps the company to present its audited accounts to the shareholders immediately after the close of the financial year.
  - v) In the periodical audit the audit report is not submitted by the auditor.

**1.7 LET US SUM UP**

Origin of audit dates back to the period of Mauryas and Hindu Kings in India. However, the growth of Accounting Profession in India is only of recent origin. The Companies Act, 1913 made the audit of accounts of Joint Stock Companies compulsory for the first time. In 1949, Chartered Accountants Act was passed and accordingly the Institute of Chartered Accountants of India was established. As a consequence, the

affairs of the profession were passed on to this Institute. Thereafter, the Companies Act, 1956 elaborated the provisions relating to accounts and audit of companies.

Auditing is the systematic and scientific examination of the books of accounts and records of a business to enable the auditor to satisfy himself that the Profit and Loss Account and the Balance Sheet are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

The term auditing has been distinguished from accounting and investigation. The main point of distinction is that accountancy is concerned with the preparation of financial statements whereas auditing is concerned with checking of these financial statements and reporting on the financial position and results of operation of the organisation. In Investigation is undertaken for some special purpose i.e., to determine the extent of fraud or to determine the purchase price of the organisation and the like.

Objectives of audit are broadly classified into : (a) Primary objective, and (b) Secondary objective. Primary objective of audit is to substantiate the accuracy of the financial statements prepared by the accountant while the Secondary objective is to detect the prevent errors and frauds.

A number of advantages can be derived from getting the accounts audited by a qualified auditor, such as early detection of errors and frauds, reliability of accounts, settlement of various types of claims, securing loans from banks and other financial institutions, etc.

Audit is classified into various types, namely, audit under statute, audit of accounts of private firms, audit of accounts of private individuals and audit of trust accounts. An auditor can adopt any one of the modes to conduct his audit of an organisation, namely, continuous audit or periodical audit or interim audit.

Besides being a chartered Accountant, an auditor should possess certain other qualities, such as, knowledge or relevant laws, intelligence, tactfulness, vigilance, honesty and integrity, courage, impartiality, broadmindedness, patience, perseverance, maintaining secretary of his client, commonsense etc.

## 1.8 KEY WORDS

**Auditing :** Systematic and scientific examination of the books of accounts and records of a business as to enable the auditor to satisfy himself that the Balance Sheet and the Profit and Loss Account are properly drawn up so as to exhibit a true and fair view of the financial state of affairs of the business and profit or loss for the financial period.

**Continuous Audit :** An audit which involves a detailed and exhaustive examination of the books of accounts at regular intervals throughout the year along with the accounting work.

**Errors :** Mistakes committed innocently and unknowingly while making entries in the books of accounts.

**Frauds :** Fictitious entries made in the books of accounts with certain motives.

**Interim Audit :** An audit which is conducted for a part of the accounting year for some specific purpose.

**Investigation :** Examination of accounts for a specific purpose.

**Qualified Auditor :** A person who is a chartered Accountant within the meaning of the chartered Accountants Act, 1949.

**Statutory Audit :** An audit undertaken under any specific Statute or Act.

**True and Fair View :** A phrase which means that the financial statements must not contain anything which is untrue, unfair, unlawful, immoral and unethical i.e., the financial statements must not contain errors and frauds.

**Trust :** Institution created mainly for the benefit of religious and charitable purposes. It may also be created for the benefit of minors and widows.

## 1.9 ANSWERS TO CHECK YOUR PROGRESS

- A 3 i) false      ii) False      iii) False      iv) False  
      v) True      vi) False      vii) False      viii) False
- B 4 i) compensating errors    ii) fraud    iii) secret reserve    iv) primary objective  
      5 i) False      ii) False      iii) False      iv) False  
      v) False      vi) True      vii) True
- C 4 i) facilities    ii) periodical audit    iii) external audit    iv) sole proprietor  
      5 i) False    ii) False    iii) True    iv) True    v) True

## 1.10 TERMINAL QUESTIONS

- 1 Define the term 'Auditing'.
- 2 Differentiate between Auditing and Investigation
- 3 What is continuous audit? Discuss its merits and demerits.
- 4 Distinguish between Interim and final Audit.
- 5 List five important qualities of an auditor.
- 6 List five advantages to a private firm for getting the accounts audited.
- 7 Discuss briefly the main and subsidiary objects of audit.
- 8 Briefly explain the following :
  - a) Errors of commission
  - b) Errors of principle
  - c) Prevention and detection of fraud
  - d) Origin of auditing.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.



## UNIT 3 AUDIT PLANNING

### Structure

- 3.0 Objectives
- 3.1 Introduction
- 3.2 Audit Planning
  - 3.2.1 Process of Planning
  - 3.2.2 Purpose of Planning
  - 3.2.3 Considerations in Audit Planning
  - 3.2.4 Importance of Audit Planning
  - 3.2.5 Audit Flow Chart
- 3.3 Preparations Before Audit
  - 3.3.1 Preparatory Procedures
  - 3.3.2 Considerations Prior to Commencement
- 3.4 Audit Programme
  - 3.4.1 Main Features of Audit Programme
  - 3.4.2 Parts of Audit Programme
  - 3.4.3 Major Aspects of Audit Programme
  - 3.4.4 Objectives of Audit Programme
  - 3.4.5 Factors for Consideration
  - 3.4.6 Contents of Audit Programme
  - 3.4.7 Advantages of Audit Programme
  - 3.4.8 Limitations of Audit Programme
- 3.5 Audit Note Book
  - 3.5.1 Contents of Audit Note Book
  - 3.5.2 Usefulness of Audit Note Book
- 3.6 Audit Working Papers
  - 3.6.1 Purpose of Audit Working Papers
  - 3.6.2 Objects of Audit Working Papers
  - 3.6.3 Reasons for Audit Working Papers
  - 3.6.4 Allocation of Audit Working Papers
  - 3.6.5 Contents of Current File
  - 3.6.6 Contents of Permanent File
  - 3.6.7 Importance of Audit Working Papers
- 3.7 Routine Checking
  - 3.7.1 Areas of Checking
  - 3.7.2 Guiding Factors in Audit Checks
  - 3.7.3 Extent of Checking
  - 3.7.4 Main Features of Routine Checking
- 3.8 Test Checking
  - 3.8.1 Relevance of Test Checking
  - 3.8.2 Precautions in Test Checking
  - 3.8.3 Auditor's Responsibility
  - 3.8.4 Balanced Approach in Checking
- 3.9 Let Us Sum Up
- 3.10 Key Words
- 3.11 Answers to Check Your Progress
- 3.12 Terminal Questions

### 3.0 OBJECTIVES

After studying this unit, you should be able to :

- explain the concept of audit planning
- describe various preparations before audit
- analyse the major aspects of audit programme
- explain the audit note book
- describe the contents of working papers
- explain the concept of routine checking and test checking.

### 3.1 INTRODUCTION

In Unit 1 and 2 you have learnt the basic concepts of auditing and the role of internal control in auditing. Audit planning is another important area which is an essential process of systematic verification and organised examination. In this unit you will learn the concept of audit planning and the basic considerations in getting ready for an audit. You will also learn the method of recording the audit work and the alternative and supplementary techniques of audit checks.

### 3.2 AUDIT PLANNING

In almost every branch of modern economic activity, there is the need for planning. Planning in audit operations too has been considered as an essential step to a productive utilisation of efforts. This gives an opportunity to organise the different aspects of audit work including vouching, verification, valuation, expression of opinion on financial statements and submission of auditor's report.

#### 3.2.1 Process of Planning

Planning is a process of doing a job in a systematic and methodical manner. Planning defines: (a) What to do? (b) How to do? (c) When to do? and (d) Who will do? Planning is an organised approach to complete a task in minimum time at minimum cost and with maximum efficiency. Planning is needed to coordinate the work and complete the assignment effectively. It is schedule of activity prepared in advance so that significant areas receive the required attention or the job is completed speedily, the work is allocated among the available staff properly. It ensures that something which is relevant does not get neglected. Planning, therefore, controls progress and assists in achieving the target on time. It also helps in enhancing the quality of output. It is thus the way to promptness and perfection in performance.

#### 3.2.2 Purpose of Planning

The major purposes of planning are :

- 1 To work with each other and with the **people** who will carry out the plans
- 2 To clarify **objectives**
- 3 To set **goals** for each division
- 4 To establish policies and standard **methods** to guide those who do the work
- 5 To develop **programmes**, strategies and schedules to keep the work moving towards the objectives
- 6 To spell out how detailed the **plans** should be
- 7 To decide who should participate in formulating **policies** and
- 8 To determine how much freedom of action should be given to **subordinates**.

Let us now discuss the considerable methods and importance of audit planning in particular.

#### 3.2.3 Considerations in Audit Planning

The Auditing Standards and Guidelines have placed considerable emphasis on audit planning. It states that the auditor should adequately plan, control and record his work at each stage of its progress. This is mainly to ensure that the audit is carried out effectively and efficiently. The aim is to provide an efficient and economic service within an appropriate time scale. The exact form and nature of audit planning, however, should be governed by the following considerations:

- 1 the **size and complexity** of the company;
- 2 the **commercial environment** in which it operates;
- 3 the **method of processing** transactions; and
- 4 the **reporting requirements** to which it is subject to.

A proper consideration of these factors will enable the auditor to appreciate the events and transactions likely to have a significant effect on the financial statements. All this helps in designing an appropriate audit approach to the assigned responsibility.

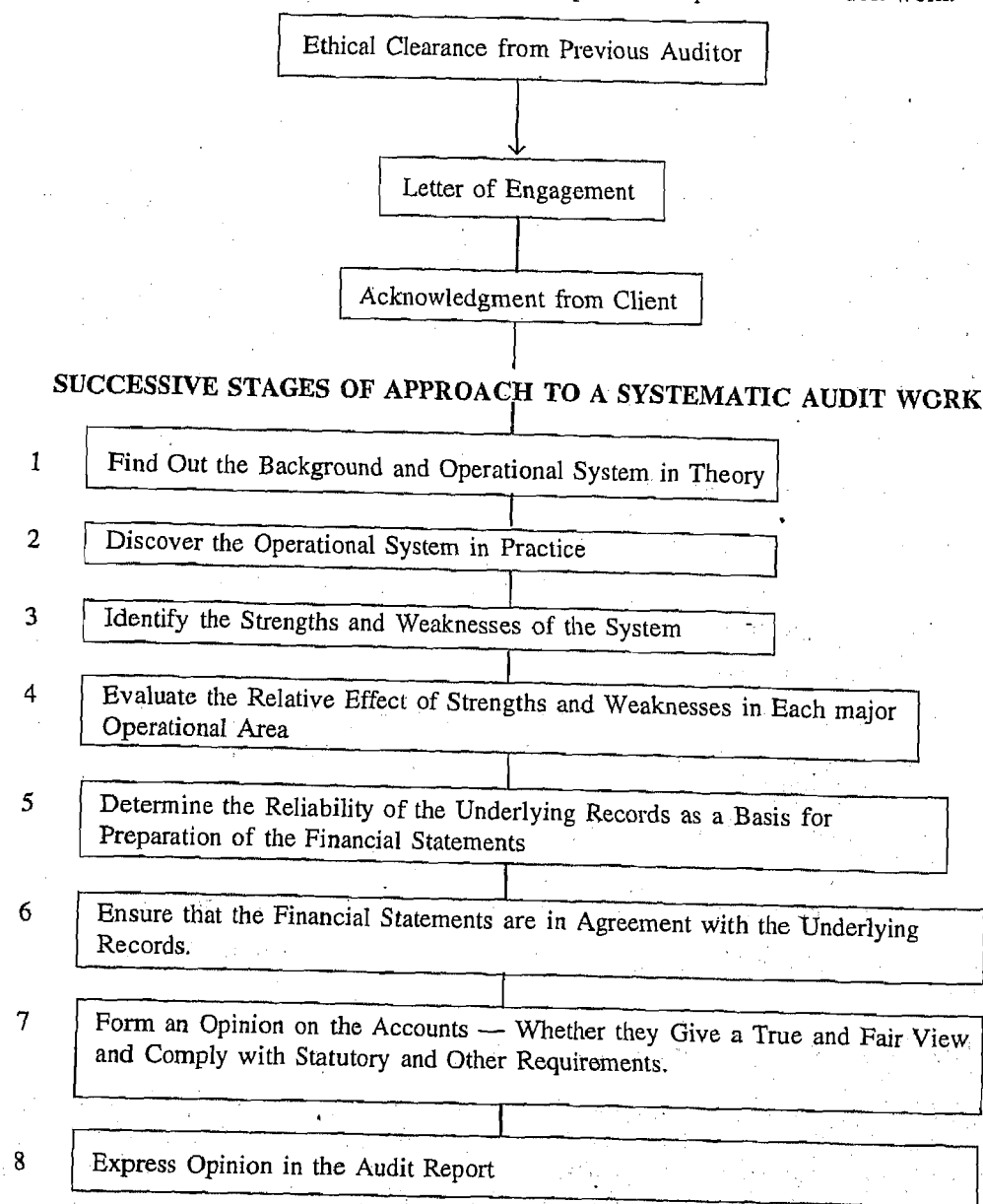
### 3.2.4 Importance of Audit Planning

Planning is an aid to good management. Adequate audit planning :

- 1 establishes the intended means of achieving the objectives of the audit;
- 2 assists in the direction and control of the work
- 3 ensures that attention is devoted to critical aspects of the audit
- 4 ensures that the work is completed expeditiously.

### 3.2.5 Audit Flow Chart

The different stages involved in audit planning may be demonstrated through the following. Audit Flow Chart which shows the sequence of operations in audit work.



### 3.3 PREPARATIONS BEFORE AUDIT

According to P.A. Bird, the basis of the modern approach is that in most cases the best method of auditing, before the stage of the critical review of the accounts, is:

- a) to ascertain the client's system of internal control,
- b) to record it,
- c) to corroborate that it is in fact working
- d) to evaluate it, and only then
- e) to carry out further work in the areas that the evaluation has shown to be weak.

Thus the auditor, before taking final decisions about the manner in which a particular audit is to be conducted, should :

- 1 consider the **audit approach** proposed to be adopted;
- 2 estimate the extent to which reliance may be placed on **internal controls** of the company;
- 3 identify any aspects of the audit which need **special attention**; and
- 4 take note of any **additional work** which has been agreed to be undertaken.

### 3.3.1 Preparatory Procedures

The procedures preparatory to an audit are as follows :

- 1 Review matters raised in the audit of the previous year which may have continuing relevance in the current year
- 2 Assess the effects of any changes in legislation or accounting practice affecting the financial statements of the company
- 3 Study interim or management accounts where these are available
- 4 Consult the management and staff of the company about the trading circumstances and significant changes in the business or its management
- 5 Identify any significant changes in the accounting procedures of the company (i.e. a new computer-based system)
- 6 Ascertain the timing of significant phases of the preparation of the financial statements
- 7 See the extent to which analyses and summaries can be prepared by the employees of the company
- 8 Estimate the relevance of nay work to be done by the internal auditors of the company
- 9 Determine the number of audit staff required, the experience and special skills they need to possess and the timing of their audit visits
- 10 Allocate the work to be undertaken and the procedures to be followed between the joint auditors, if any.

### 3.3.2 Considerations Prior to Commencement

The major considerations before the commencement of audit are as follows:

1. Ensure that the **appointment** is in order under the provisions of law
- 2 Enquire from the retiring auditors the reasons for the **changes**, if the appointment is in place of another auditor
- 3 Obtain necessary **information** and instructions about the nature of work, scope of duties, expected date of completion of audit, audit fee, etc.
- 4 Examine the accounting **system** followed by the company and identify the weaknesses, if any
- 5 Get a list of various **books** maintained, those who maintain them and their specimen signatures
- 6 Ascertain the system of **internal control** from the company and evaluate its effectiveness.

- 7 Collect a list of the different officers of the company, their duties and powers and their specimen signatures
- 8 Visit the works and acquire some technical knowledge to develop familiarity with the nature of the operation
- 9 Ask the company to balance the books, prepare the final accounts, arrange the vouchers in order, finalise the debtors' and creditors' schedules and file important legal papers, contracts, list of securities, etc.
- 10 Procure a copy of the audited balance sheet of the previous year and ensure that the opening balances of the current year tally with the closing balances of the last year
- 11 See the auditor's report of the previous year and take note of the state of affairs last year or the points raised by the previous auditor.
- 12 Refer to the accounting and financial provisions of the Article and Memorandum of Association of the company and of its prospectus and
- 13 Find out if some important resolutions have been passed at the meetings of the Board of Directors and obtain copies of the minutes affecting accounting matters of the company.

**Check Your Progress A**

- 1 What factors should be taken into account in Audit Planning?  
.....  
.....  
.....  
.....
- 2 Why do we need Audit Planning?  
.....  
.....  
.....  
.....
- 3 Why do we try to ascertain the system of internal control in operation before commencing audit?  
.....  
.....  
.....  
.....
- 4 What is the relevance of referring to the auditor's report of the last year before the current audit?  
.....  
.....  
.....  
.....
- 5 State whether the following statements are True or False.
  - i) Auditors must work in consultation with the officers of the company.
  - ii) Certain important documents must be seen by the auditor before he decides to accept his assignment.

- iii) If errors continue in accounts owing to a defective system accounting followed by the company, the auditor is not responsible for the correctness of the financial statements.
  - iv) Major recommendations of the Board of Directors in respect of financial matters of the company need not be seen by the auditor.
  - v) Adequate preparations in advance of commencement of audit work make the job easier.
  - vi) An auditor is not responsible for negligence in duties shown by his staff in course of checking.
6. Fill in the blanks.
- i) A list of books of account must be ..... by the auditor before commencement of audit.
  - ii) It is ..... for the auditor to do the entire checking of accounts himself.
  - iii) Balancing of books of account is the responsibility of the .....
  - iv) An auditor should ..... the effectiveness of the system of internal control before conducting audit.
  - v) An auditor must be ..... in giving his opinion on the set of accounts which he examines.
  - vi) An auditor must be ..... about the significant changes in the accounting procedures of the company.

**3.4 AUDIT PROGRAMME**

Audit Programme is an outline of procedures to be followed in order to arrive at an opinion concerning the financial statements of a company.

**3.4.1 Main Features of Audit Programme**

The main features of an Audit Programme are as follows:

- 1 It is a method of planning, supervising and controlling the audit performance.
- 2 It is a systematic approach to audit.
- 3 It is a planned procedure of examination and steps of verification.
- 4 It is a detailed plan of audit techniques to be adopted and applied for achieving the objectives of audit.
- 5 It specifies the work to be done and the manner in which it should be completed within the estimated time.
- 6 It shows the tasks to be carried out and some relevant instructions to the audit staff in respect of the extent of checking to be done for examination of evidence.

As part of audit planning, it is advisable that the auditor prepares a written programme of audit tests to be performed in respect of the company under audit. He should then tick and sign the appropriate section of the programme as the work is completed.

**3.4.2 Parts of Audit Programme**

An Audit Programme should normally have two parts:

- 1 **Detailed Audit Programme** showing the work required to form an opinion on the reliability of the books as a basis for the accounts; and
- 2 **Balance Sheet Audit Programme** showing the work necessary for the verification of the items appearing in the Profit and Loss Account and Balance Sheet of the company.

### 3.4.3 Major Aspects of Audit Programme

A good Audit Programme should :

- 1 contain complete details about the work to be done
- 2 be in writing
- 3 be preferably drawn by the auditor himself
- 4 incorporate a clear distribution of work among the audit staff
- 5 state the responsibilities of the staff of the company
- 6 provide adequate opportunity for flexibility on the basis of periodical review of the programme and performance.

### 3.4.4 Objectives of Audit Programme

The main objectives of preparing an Audit Programme are :

- 1 To improve the coordination and integration of different parts of the audit
- 2 to check the progress of the audit work from time to time
- 3 to record the audit procedures performed in respect of the different branches of verification and examination
- 4 to maintain a time schedule of the completion of the audit work
- 5 to have a fair allocation of duties of audit staff and fix their responsibilities
- 6 to control the quality of the audit performance
- 7 to keep as an evidence the record of the work done, the dates on which it was done, who did it and how was this done.

### 3.4.5 Factors for Consideration

The factors which should be considered in preparing an Audit Programme are :

- 1 the effectiveness of the system of internal control being followed by the company;
- 2 the adequacy and reliability of the accounting procedures in the company;
- 3 the relevance and reliability of evidences available in the company;
- 4 the possibilities of errors and frauds in the company;
- 5 the procedures which may be appropriate for the purposes of verification
- 6 the timing of the work in relation to the date of the balance sheet.
- 7 any special features of audit relating to the particular company; and
- 8 size, nature and extent of operations of the company.

It is thus obvious that separate audit programmes have to be prepared for different companies.

### 3.4.6 Contents of Audit Programme

The main items to be incorporated in drafting an Audit Programme should be:

- 1 Name of the company
- 2 Nature of operations of the company
- 3 Date of commencement of audit
- 4 Duration of audit exercise
- 5 Accounting system adopted by the company
- 6 Effectiveness of internal control in the company
- 7 Points of caution as per the auditor's report of the previous year
- 8 Schedule of checking of books relating to: (a) cash and petty cash, (b) purchase and purchase returns, (c) sales and sales return, (d) bills receivable and bills payable, (e) journal, (f) ledger accounts, and (g) statutory requirements.

### 3.4.7 Advantages of Audit Programme

Benefits of Audit Programme are as follows:

- 1 Gives a clear set of instructions to the audit staff on the work to be carried out;
- 2 Provides an up-to-date record of the progress of the work;
- 3 Documents the names of the staff who performed the different sections of the audit;
- 4 Offers an opportunity to the supervisors, auditors or their partners to review the work done;
- 5 Avoids duplication of work;
- 6 Reduces the possibilities of getting a work overlooked;
- 7 Keeps an evidence of work performed against the charge of negligence;
- 8 Distributes the work among different levels of staff commensurating their qualifications with the nature of the job to be done;
- 9 Enhances the efficiency of the audit staff;
- 10 Maintains continuity of audit work despite changes in the placement of the audit staff;
- 11 promotes uniformity in the audit work;
- 12 Serves as a guide to audits in subsequent years;
- 13 Shows a total perspective of the work to be performed;
- 14 Allows an easier planning, identification and segregation of the job and the personnel needed to complete them;
- 15 Minimises the risks of audit and makes it a systematic, organised, coordinated and planned exercise;
- 16 Assigns responsibility to audit staff;
- 17 Helps control of various audit assignments at a time; and
- 18 Facilitates the final review of the audit work before the report is signed.

### 3.4.8 Limitations of Audit Programme

Audit Programme, however, has the following limitations :

- 1 Makes the work almost mechanical — sometimes the work is done without understanding the objectives behind it.
- 2 Gives rigidity of approach — the required flexibility to devote additional attention to some critical areas becomes difficult.
- 3 Discourages personal initiatives or efficiency on matters which demand some more time or energy.
- 4 Disclose to the company's staff the tests being performed and the part of the work which has already been completed.

Yet it must be appreciated that the concept of Audit Programme has enough usefulness in the process of audit. A realistic assessment of the situation and a careful planning of affairs, therefore, can very well remove the above limitations of the Audit Programme.

## 3.5 AUDIT NOTE BOOK

An Audit Note Book is a sort of diary maintained by the audit staff recording their difficulties and experiences in course of audit, matters for discussion, special points observed, enquiries made, queries raised, replies received, correspondence recorded, etc. It serves as a source of information about the audit work and the points which need to be remembered. It also gives the benefit of being a continuous link in audit work, as it records the work completed as well as the matters awaiting further follow up.

An Audit Note Book combines recording of : (i) **General Information** in respect of the audit, and (ii) **Special Points** of significant matters observed during the audit of accounts.

**3.5.1 Contents of Audit Note Book**

An Audit Note Book usually contains the following information :

- 1 List of books of account in use in the company
- 2 Nature of the business carried on in the company
- 3 Names of the principal officers of the company alongwith their powers, duties and responsibilities.
- 4 System of accounting and internal control in operation
- 5 Technical terms used in the business
- 6 Relevant extracts from the minutes and contracts
- 7 Major provisions of the Articles and Memorandum of Association affecting accounts and audit
- 8 Financial and administrative structure of the organisation
- 9 Particulars of financial and accounting policies followed by the company
- 10 Points awaiting further explanation and clarification
- 11 Queries in course of audit and their disposal
- 12 List of missing vouchers which need duplicates or certificates of payment
- 13 Mistakes and errors discovered during the audit
- 14 Matters to be discussed with the auditor
- 15 Dates of commencement and completion of the audit work
- 16 Totals or balances of important books of account
- 17 Points to be included in the auditor's report.

An Audit Note Book, therefore, takes note of all irregularities identified in course of the audit, unsatisfactory arrangements, weaker financial administration, special points of consideration at the time of verification of final accounts and important matters for future reference.

**3.5.2 Usefulness of Audit Note Book**

The advantages of an Audit Note Book are :

- 1 Records important matters relating to the audit and helps future reference
- 2 Facilitate preparation of audit reports
- 3 Assists the auditor in assessing the efficiency of his staff
- 4 Serves as a reliable documentary evidence in support of the audit work and as a defence for negligence
- 5 Provides guidance to the audit staff at subsequent audits
- 6 Helps framing of future audit programmes taking note of the weaknesses identified in the system in course of examination.

Thus an Audit Note Book is normally maintained to record important points affecting the audit.

**Check Your Progress B**

- 1 What is an Audit Programme?

.....  
 .....

- 2 How can you make an Audit Programme flexible?

.....  
 .....

- 3 What is an Audit Note Book?

.....  
 .....

- 4 What matters should be specially recorded in an Audit Note Book?

.....  
 .....

- 5 State whether the following statements are True or False :

- i) An Audit Programme need not be in writing.
- ii) An Audit Programme guides the work to be done and the methods which should be adopted for completing it.
- iii) An Audit Programme serves as an evidence of a true and fair view of the state of affairs of the company.
- iv) An Audit Programme shows how the financial statements of the company were prepared.
- v) An Audit Programme should take note of the effectiveness of the system of internal control followed by the company.
- vi) An Audit Programme will help in fixing responsibilities and knowing reasons why a particular checking was not done effectively.
- vii) Distribution of duties to audit staff for checking of accounts should invariably be made in consultation with the management of the company so that they work together to complete the task in time.
- viii) An Auditor should revised his programme if his staff advises him to make some changes in the time allotted for checking of books of account.
- ix) An Audit Note Book maintained by an audit staff need not be shown to the auditor.
- x) Material errors and frauds discovered during the audit should be recorded in the Audit Note Book.

**3.6 AUDIT WORKING PAPERS**

Audit Working Papers are written private materials prepared by the auditor for each audit separately. Such papers include :

- 1 relevant accounting information obtained from the company,
- 2 methods of examination used in course of audit,

3 auditor's conclusions along with their reasons, and

4 financial statements.

Audit Working Papers incorporate essential facts about accounts so as to serve as a source of reference during the audit as well as during the subsequent years of audit relations. Such papers are preserved by the auditor to record the work done and provide the accounting information relevant to the assignment.

### 3.6.1 Purpose of Audit Working Papers

Adequate Working Papers are prepared and maintained for the following purposes :

- 1 to show the nature of work done and the persons who did it;
- 2 to keep the explanations and information received and the source through which they were obtained; and
- 3 to record the decisions taken on various points and the persons who took such decisions.

Thus Audit Working Papers serve as an evidence of the work done by the auditor and his staff.

### 3.6.2 Objects of Audit Working Papers

The main object of the Audit Working Papers is to record and demonstrate the steps which are taken by the auditor to enable him to form an opinion on the accounts upon which he is required to report. To achieve this object, the working papers provide :

- 1 a means of controlling the current year's audit work and the basis on which to plan the following year's audit,
- 2 details of the work carried out by the auditor,
- 3 schedules in support of the accounts, and
- 4 information about the business whose accounts have been audited including its recent history.

### 3.6.3 Reasons for Audit Working Papers

The main reasons why the preparation of Audit Working Papers is supported as a standard audit activity are :

- 1 to satisfy the auditor, through a review of the actions of his subordinates, that the work delegated by him has been properly performed;
- 2 to serve for future reference details of problems encountered together with evidence of work performed and conclusion drawn there from in arriving at the audit opinion;
- 3 to facilitate the auditor in adopting a methodical approach;
- 4 to enable the person conducting an audit control what he is doing;
- 5 to ascertain if the accounts show a true and fair view as a part of the audit responsibility; and
- 6 to form a permanent record and a basis for succeeding audits.

### 3.6.4 Allocation of Audit Working Papers

Audit Working Papers should normally be divided between the following two files :

- 1 Current File, and
- 2 Permanent File

The Current File of Audit Working Papers relates primarily to the set of accounts being audited during the current year. The Permanent File, however, contains matters of continuing importance affecting the company or the audit.

### 3.6.5 Contents of Current File

The usual contents of a Current File are those working papers which are of utility only in the year of audit.

Example of Audit Working Papers to be placed in a Current File are as follows :

- 1 A copy of the accounts on which the auditors are reporting, authenticated by directors' signatures
- 2 An Internal Control Questionnaire or other record designed to ascertain the adequacy of the system of internal control
- 3 An Audit Programme supplemented by particulars and dates of the work carried out and precise details of audit tests and their result
- 4 A schedule for each item in the Balance Sheet, preferably including comparative figures showing its make-up and how existence, ownership and value or liability have been verified
- 5 A schedule supporting each item in the Profit and Loss Account, preferably including comparative figures and such other items in the trading or subsidiary accounts as may be necessary
- 6 A check-list concerning compliance with statutory disclosure provisions
- 7 A record showing queries raised during the audit and their disposal, with notes where appropriate for attention for the following year.
- 8 A schedule of important statistics or working ratios; significant variations will need to be explained
- 9 A record or extract of minutes of meeting of the directors and shareholders
- 10 Copies of letters to the company setting out any material weakness or matters with which the auditors are dissatisfied in respect of the accounts or control procedures
- 11 Letter of representation, i.e. written confirmation of information and opinions expressed in respect of matters such as stock value and amount of current and contingent liabilities.

Thus a Current file relates primarily to the set of accounts being audited.

### 3.6.6 Contents of Permanent File

A Permanent File should contain matters of continuing importance affecting the company or the audit. This file should normally include the following :

- 1 Memorandum and Articles of Association and other appropriate statutory or legal regulations
- 2 Copies of other documents and minutes of continuing importance
- 3 A short description of the type of business carried on and the places of business
- 4 List of accounting records and responsible officials with plans of organisation
- 5 Statements showing a note of any accounting matters of importance such as history of reserves and bases of accounting methods adopted
- 6 The company's accounting instructions on internal accounting, internal auditing and stock-taking.

Thus a Permanent File contains papers relating to some basic information of a continuous nature, such as the constitution, organisation, management, policies, systems and procedures of the company.

The contents of Audit Working Papers, therefore, include : (a) Audit Programme (b) Details or Queries (c) Detailed Schedules (d) Important Confirmations (e) Management Certificates (f) Relevant Abstracts (g) Relating Correspondence (h) records of Balances (i) Significant Points (j) Audit Assessments (k) Major Conclusions.

### 3.6.7 Importance of Audit Working Papers

The advantages and importance of Audit Working Papers are as follows :

- 1 Guides the auditors as to what work has been performed
- 2 Supports the audit conclusions
- 3 Summarises all significant matters identified which may require the exercise of judgement
- 4 Records the relevant information received from the management as well as from third parties
- 5 Demonstrates the facts which were known at the time the auditor reached his conclusion and that, based on those facts, the conclusion was reasonable
- 6 Improves the efficiency with which audit is conducted
- 7 Helps to instruct the audit staff
- 8 Facilitates delegation of work
- 9 Provides a means to control the quality of the audit work
- 10 Serves as a documentary evidence of the care and skill employed by the auditor during his examination
- 11 Maintains confidentiality and safe custody of facts discovered through audit investigation
- 12 Acts as a basis for weaknesses in the internal control system being pointed out to the company and auditor's advice in those areas
- 13 Assists audit planning in succeeding years on the basis of the audit experiences of the current year
- 14 Expedites finalisation of audit report
- 15 Identifies points, documents, policies or transactions which need particular attention in the future
- 16 Outlines the appropriate sequence of audit operations suitable to the organisation after the required changes made in course of verification.

Audit Working Papers, therefore, have much utility in a methodical system of audit.

#### Check Your Progress C

- 1 What is the main purpose of Audit Working Papers?  
.....  
.....  
.....
- 2 What are the different types of information which should be collected in a Current File?  
.....  
.....  
.....
- 3 What is the need for having a Permanent File?  
.....  
.....  
.....

- 4 How can Audit Working Papers help the auditor?  
.....  
.....  
.....

5 State whether the following statement is True or False :

- i) A copy of the Audit Working Papers should also be given to the company for their reference.
- ii) Audit Working Papers maintain a record of work done and the strength or weaknesses of the system obtaining in the organisation.
- iii) Any relevant information about the company gathered by the auditor from third parties should be incorporated in the Auditor Working Papers.
- iv) The purpose of Audit Working Papers is served as soon as the audit report for the year is submitted: it need not be retained for the future.

### 3.7 ROUTINE CHECKING

You have learn that the process of auditing is primarily a method of verification of correctness of accounts. This needs checking the correctness or otherwise of the books and the transactions.

#### 3.7.1 Areas of Checking

Through a proper process of checking, the auditor wants to ensure that :

- 1 the transaction is supported by relevant and reliable evidence;
- 2 the transaction is authorised in accordance with the system of internal control operated by the company;
- 3 the transaction is consistent with the company's normal course of business;
- 4 the terms of the transaction appear to be reasonable;
- 5 the transaction took place within the period under review;
- 6 all calculations of cost, discount, etc. are arithmetically correct;
- 7 the income or expenditure has been correctly allocated between capital or revenue; and
- 8 the transaction has been recorded in the books of account in accordance with the accepted principles of accounting.

It is by proper checking, therefore, that the auditor ascertains whether the books and records from a reliable basis for the preparation of accounts, and the financial statements show a true and fair view of the state of affairs of the business.

#### 3.7.2 Guiding Factors in Audit Checks

Decisions in respects of the volume or depth of checking to be done for the audit of a particular company are normally governed by the following factors:

- 1 Size of the company under audit
- 2 Effectiveness of the system of internal control as per auditor's appraisal
- 3 Efficiency of the system of internal control in practice
- 4 Adequacy of accounting system

- 5 Reliability of accounting books and records
- 6 Possibilities of errors and frauds
- 7 Degree of confidence placed on the organisation
- 8 Length of time available for audit.

As these factors generally vary from company to company, the auditor takes a specific decision in each case about the extent of checking to be done in that company on the basis of his own assessment of the situation. Moreover, depending upon the changing circumstances, the audit decisions may also vary from year to year in respect of the same company.

### 3.7.3 Extent of Checking

The nature and extent of checking to be done is primarily a matter of judgment of the auditor. In the connection, he is generally guided by the following considerations:

- 1 The exact manner in which the audit is conducted should mainly depend upon the size and circumstances of the company
- 2 The extent to which reliance can be placed upon the system of internal control adopted by the company is a matter of personal evaluation for the auditor
- 3 The auditor should determine the nature, scope and extent of checking the completeness and correctness of accounts in each case separately
- 4 The method and type of checking required to satisfy him about the correctness of transactions as recorded in the books of account are also matters of his personal decision
- 5 In the interest of an effective audit, it is imperative that a systematic approach is made to checking of all accounting records
- 6 The quantum and technique of checking must be decided on a standard and recognised basis
- 7 There are no legal provisions regarding the volume of work to be done, the method of doing it or the extent to which it should be done.
- 8 The major concern of an audit is to ascertain the correctness of accounts through an appropriate method of checking as a basis of auditor's opinion on the final accounts
- 9 It is through this checking that the auditor is able to determine the extent to which he can rely upon: (a) the system of recording and processing transactions as adopted by the company (b) the adequacy of its accounting system as a basis for the preparation of financial statements (c) the correctness of entries in the books of account and (d) a true and fair view of the state of affairs as shown by its financial statements which the auditor is going to endorse.

Hence there is need for proper checking in the process of auditing.

### 3.7.4 Main Features of Routine Checking

This is a **detailed checking** of all transactions as recorded in the books of original entry and the subsidiary books, and also of all ledger posting. Some of the salient features of the system of Routine Checking are as follows:

- 1 Routine Checking is a **traditional** system of audit
- 2 This involves checking of **each and every** transaction of the business
- 3 This is a method of **extensive** checking
- 4 This process of checking takes more time and consumes higher cost
- 5 This method of checking does not necessarily **discover** material errors and frauds

## 3.8 TEST CHECKING

Test checking is a method of examining a selected number of items. It checks a representative sample from a large population of similar items. It is a technique of selective verification of an arbitrary percentage of transactions. The quantum of test checking is determined by the auditor's judgement and his personal assessment of situation; it may vary from 5 to 50% checking of the items selected at random.

### 3.8.1 Relevance of Test Checking

In many cases, the number of transactions is so large that it often becomes difficult as well as unnecessary to check each and every item within the limited time available for audit. Test check approach, therefore, reduces the work of the auditor. Test Checking is a method of partial checking or selective checking. It is different from Routine Checking where each and every item is put under examination from beginning to the end. As detailed checking is considered unnecessary in every situation, the method of test checking is the one which is widely used in practice.

### 3.8.2 Precautions in Test Checking

As Test Checking is a selective approach of examination of accounts, this needs a number of precautions such as :

- 1 Include in the check entries of every description
- 2 Select the entries to be checked at random
- 3 Verify greater number of entries relating to the opening and closing parts of the accounting year
- 4 Extend the check to the work of every accounting staff
- 5 Avoid test check of some important books like Cash Book where the transactions should be checked 100%
- 6 Distribute the checking to different periods and entries at each audit anticipate it
- 8 Determine the size and selection of the sample without bias
- 9 Take care of the degree of risk involved in ignoring the checking of the substantial number of item
- 10 Extend the area of checking if the test check discloses some material irregularities or suspicious results
- 11 Choose entries for examination keeping in view the nature, size and amount of the transactions.

### 3.8.3 Auditor's Responsibility

In respect of the method of checking applied by the auditor, he should be careful about the following :

- 1 In case the test check approach fails to detect some errors or frauds, the auditor is held responsible for negligence in the performance of his duties; this implies his failure to exercise reasonable care and skill in audit.
- 2 Test checking cannot be used as a defence against negligence of duties, because the statutes expect the auditor to express an opinion on the true and fair view of the state of affairs of the business; how this opinion is formed is the responsibility of the auditor himself.
- 3 Test checking is not a legally acceptable basis of checking and it does not guarantee any specified degree of reliability on the entire set of transactions; it is only a broad indicator of results obtained through the process of selective verification
- 4 While the technique of test checking is commonly used by the auditors, they remain conscious of the risks and limitations too; they apply their care and skill on an extended level as soon as they discover that the results demonstrated by test checking raise an alarm for further investigation.



### 3.8.4 Balanced Approach in Checking

It is necessary to emphasise here that a detailed examination of transactions is possible only in a few selected cases. Where an appraisal of the system of internal control by the auditor shows satisfactory results, he may rely on Test Checking rather than on Routine Checking.

Yet you must make it clear that the two methods of checking do not substitute each other; they are often supplementary. In fact, audit makes a combined use of the two methods. Test checking of selected items, therefore, is joined by detailed Routine Checking and examination in depth, particularly in areas which demand greater attention.

It is now widely suggested that Tests Checking should be used on the basis of statistical techniques of sampling. This is with a view to achieve a suitable balance between the following two extremes while measuring the precision and reliability of accounting information :

- a complete check of all items, and
- a sample check so small as to run the risk of over-looking a material number of errors.

It is further suggested that the statistical sampling techniques should also make use of stratification in audit checks, which is a still more sophisticated and dependable system. Stratification divides the field under review into different layers according to the size of the items. It then becomes possible to verify a large part of the total value by examining a small number of items. This helps the auditor in reducing the possibilities of risk consequent upon ignoring the verification of a number of items which have not been included in the sample size.

### 3.9 LET US SUM UP

**Audit Planning** is an essential process of systematic verification and organised examination. The exact nature of audit planning, however, should be guided by the conditions obtaining in the company. Thus a careful planning of audit operations in advance ensures a smooth audit. Adequate preparations must be made before commencement of audit. This will: (a) allow the auditor to design an appropriate programme of audit, (b) develop suitable procedures of verification, (c) apply proper techniques of checking, (d) ensure timely completion of work, and (e) give full opportunity to satisfy that the financial statements shows a true and fair view of the state of affairs.

**Audit Programme** helps planning, supervision and control of audit performance. It : (a) defines the works to be done, (b) the procedures to be adopted, (c) the duties to be performed by the audit staff, the time schedule to be followed for audit, and (e) the extent of checking to be conducted for verification. An audit programme, therefore, is a means to ensure quality of audit performance and is an evidence of the record of work done by the auditor.

An **Audit Note Book** is a record of some important information gathered or experienced in course of verification of accounts. It includes significant matters observed during the audit which may be of considerable use at the time of finalisation of reports as well as during successive audits.

**Audit Working Papers** keep a file of such useful information which relate to the company, its accounts, record done, decisions taken and the basis of such decisions in respect of the reporting responsibilities of the auditor. All such papers are classified under two main categories: (a) Information directly related to the set of accounts under audit during the year, preserved in a Current File, and (b) Information of a relatively more continuous usefulness to the audit of the company in successive years maintained in a Permanent File.

**Routine Checking** is a detailed and extensive method of checking adopted for the purpose of verification of each and every item of a book, where as **Test Checking** is based on a selective examination of transactions so as to avoid verification of items which may not be of any material importance so far as the purposes of auditing are concerned. The different components of audit planning, therefore, play a crucial role in lending a firm foundation to an effective, economical and efficient audit performance.

### 3.10 KEY WORDS

**Financial Statements** : Trading and Profit and Loss Account, Balance Sheet, Statement of Sources and Uses of Funds plus any other relevant statement forming part of the final operations results of the business.

**Flow chart** : A diagrammatic sequence of operations showing the process of a work from its commencement to the conclusion.

**Internal Audit** : Audit within the organisation by its own staff.

**Internal Control** : The system of checks devised and operated by the company within the organisation to minimise the possibilities of errors and frauds.

**Joint Audit** : Where more than one auditor are appointed to conduct the audit of a company.

**Random Check** : When each and every item of a population has an equal chance of being included in the sample selected for verification.

**Test** : The process of verifications of an entry, an asset, a statement or a document.

**True and Fair** : The correct financial position which is without any manipulation or window dressing.

### 3.11 ANSWERS TO CHECK YOUR PROGRESS

- A 5 (i) False, (ii) True, (iii) False, (iv) False, (v) True, (vi) False  
 6 (i) Collected, (ii) Unnecessary, (iii) Company, (iv) Evaluate, (v) Independent/Free/Honest, (vi) Careful  
 B 5 (i) False, (ii) True, (iii) False, (iv) False, (v) True, (vi) True, (vii) False, (viii) True, (ix) False, (x) True  
 C 5 (i) False, (ii) True, (iii) True, (iv) False

### 3.12 TERMINAL QUESTIONS

- What documents are required from the company to be produced before the auditor at the time of the commencement of audit?
- Discuss the importance of Audit Planning in ensuring correct financial statement
- Distinguish between an Audit Programme and an Audit Note Book.
- State the characteristics of good working papers.
- Explain the relevance of having two separate files for Audit Working Papers.
- What is routine Checking? Under what circumstances is it useful to apply?
- State the risks and limitations of Test Checking.

**Note** : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

### SOME USEFUL BOOKS

- Pörwal, L.S. & G.K. Kapoor, Auditing, *Theory and Practice*; Kitab Mahal, Allahabad, (Chapters 1, 2 & 3)  
 Dinkar Pagare, *Principles and Practice of Auditing*. Sultan Chand & Sons, New Delhi.  
 Shalita, Dr. T.R. *Auditing*. Sahitya Bhawan; Agra, (Chapters 1, 2 & 3)  
 Kamal Gupta and Ashok Arora, *Fundamentals of Auditing*; Tata McGraw-Hill Publishing Co. Ltd., New Delhi (Chapters 1 to 5).

---

## UNIT 4 VOUCHING OF CASH TRANSACTIONS

---

### Structure

- 4.0 Objectives
- 4.1 Introduction
- 4.2 Meaning, Objectives and Importance of Vouching
  - 4.2.1 Definition of Vouching
  - 4.2.2 Objectives of Vouching
  - 4.2.3 Importance of Vouching
- 4.3 Voucher
  - 4.3.1 What is a Voucher ?
  - 4.3.2 Types of Vouchers
  - 4.3.3 Points to be Noted in a Voucher
- 4.4 Vouching of Cash Receipts
  - 4.4.1 Cash Sales
  - 4.4.2 Receipt from Debtors
  - 4.4.3 Sale of Investments
  - 4.4.4 Interest and Dividends
  - 4.4.5 Rent Received
  - 4.4.6 Sale of Fixed Assets
  - 4.4.7 Commission Received
- 4.5 Vouching of Cash Payments
  - 4.5.1 Cash Purchases
  - 4.5.2 Cash Paid to Creditors
  - 4.5.3 Wages
  - 4.5.4 Salaries
  - 4.5.5 Rent Paid
  - 4.5.6 Capital Expenditure
  - 4.5.7 Travelling Expenses
  - 4.5.8 Petty Cash
  - 4.5.9 Postage
- 4.6 Let Us Sum Up
- 4.7 Key Words
- 4.8 Answers to Check Your Progress
- 4.9 Terminal Questions

---

### 4.0 OBJECTIVES

---

After studying this unit, you should be able to:

- define the term 'vouching'
- explain the objectives and importance of vouching
- distinguish vouching from routine checking
- identify voucher and its essential contents
- undertake vouching of cash receipts and cash payments.

---

### 4.1 INTRODUCTION

---

After completing audit planning, preparations before audit, audit programmes, audit note book, audit working papers etc. and deciding on whether to adopt routine checking or test checking, the auditor, as a next step, should proceed with the examination of accounting entries passed in the books of account during the period under review. In this task, the auditor is mainly concerned with collection and evaluation of evidence to establish the accuracy and authenticity of facts that have actually taken place. This process is called vouching. It may relate to the cash transactions as well as the trading transactions. In this unit we shall discuss the vouching of cash transactions viz. cash receipts and cash payments.

---

### 4.2 MEANING, OBJECTIVES AND IMPORTANCE OF VOUCHING

---

You know that the auditor is required to certify the financial statements prepared by the

accountant as to their exhibiting a true and fair view of the results of operations and state of affairs of the business. The auditor will be failing in the discharge of this duty unless he tries to establish accuracy and authenticity of all the transactions recorded in the books of account. The process of audit starts with the collection and evaluation of evidence in support of the entries made in the books to establish their accuracy and authenticity. The auditor must be satisfied with the adequacy and reliability of such evidences. Thus, the exercises made by the auditor in establishing accuracy and authenticity of the accounting entries passed in the books of account with reference to adequate and reliable evidences are technically called 'vouching'. In other words, vouching in its true sense means testing the truth of all the entries made in the books of account.

#### 4.2.1 Definition of Vouching

Different authors have defined vouching in various ways. The following are a few of the important definitions.

Lawrence Dicksee has defined vouching as *an act of comparing entries in the books of accounts with documentary evidence in support thereof.*

Ronald A. Irish has defined vouching as *a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction.*

According to F.R.M. De Paula, *Vouching does not mean merely the inspection of receipts with the cash book, but includes the examination of 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.*

According to Arthur W. Holmes, *Vouching is the examination of the underlying evidence which is in support of the accuracy of the transaction. The process of vouching is intended to substantiate an entry by providing authority, ownership, existence and accuracy.*

If we analyse the above definitions, we can come to the conclusion that vouching is a method of examination to not only substantiate an entry in the books of account with documentary evidences, but also to see that these evidences are adequate, reliable and really connected with the business. For this, the auditor should go beyond the books of account i.e. he should go to the very source of the transaction to see that it is related to the business and is properly authorised.

#### 4.2.2 Objectives of Vouching

The main objectives of vouching are :

- 1) To examine the accounting entries recorded in the books of accounts with reference to documentary evidences known as vouchers.
- 2) To examine the adequacy and reliability of such documentary evidences.
- 3) To examine the authenticity of the transactions recorded in the books of account.

#### 4.2.3 Importance of Vouching

Vouching is regarded as **the very essence of auditing** because the concept of evidence is fundamental to auditing and all audit techniques and procedures are derived from it. It helps the auditor in understanding the types of evidence available, in collecting it by means of various audit techniques and in evaluating its adequacy and reliability to support accounting entries. In vouching the success of an auditor depends to a very great extent upon his skill, intelligence, critical bent of mind, observation, power of judgement and tactfulness with which he has to handle his work.

It should be clearly borne in mind that no amount of routine checking can reveal serious discrepancies, errors of principle and carefully planned frauds. Such checking can only detect clerical and minor errors. There is no denying the fact that serious discrepancies, errors of principle and clever frauds can be detected only through proper vouching. Therefore, it is very important that the auditor should undertake vouching of each and every item appearing in the books of accounts with great care. It is through vouching that the auditor can satisfy himself as to the accuracy, authenticity and completeness of the transactions recorded in the books of accounts and only then he can certify that the financial

statements exhibit a true and fair view of the results of operations and state of affairs of the business.

In case, the auditor is negligent in the discharge of his duties, he will be held guilty as was decided in the case of Armitage vs. Brewer & Knott. It was held in this case that an auditor was liable for damages if he failed to detect irregularities and defalcations which were apparent on the face of the vouchers.

### 4.3 VOUCHER

#### 4.3.1 What is a Voucher ?

A voucher is a documentary evidence produced in support of each and every entry made in the books of account. The vouchers constitute the main source of evidence available to the auditor. The auditor has to rely upon the vouchers to a great extent in order to form an opinion about the accuracy and authenticity of the entries made in the books of accounts. Thus, vouchers include lots of documents like purchase invoices, copies of sales invoices, debit/credit notes, bills, cash memos, copies of cash memos, counter-foils of receipts, paying-in-slips, cancelled cheques, receipts given by payees, agreements, minutes, insurance policies, order book and all other documents which are created as and when transactions take place.

#### 4.3.2 Types of Vouchers

From the point of view of the auditor, the large number of vouchers available in various audit situations may broadly be classified as under :

- 1) Vouchers which are not prepared by the organisation under audit, such as, purchase invoices, insurance policy, receipts given by payees etc. These vouchers are generally considered reliable as evidence for the transactions represented by them.
- 2) Vouchers which are prepared by the Organisation under audit, but validated by independent sources. For example, cheques prepared by the organisation under audit received by the payees. These vouchers also provide reliable evidence.
- 3) Vouchers which are prepared and used completely within the Organisation. This category, comprises the majority of vouchers and their reliability as evidence depends upon various circumstances, such as, whether they bear the signatures of some responsible officer and whether there is a sound system of internal control.

From the point of view of the nature of vouchers, they can be further classified as under :

- a) **Primary Voucher** : It refers to an original voucher in writing which is produced in support of a transaction like purchase invoice.
- b) **Collateral Voucher** : It refers to a subsidiary voucher which is produced in the absence of an original voucher in support of a transaction like carbon copies of cash memos.

#### 4.3.3 Points to be Noted in a Voucher

An auditor should bear in mind the following points while examining a voucher:

- 1) All the vouchers should be consecutively numbered and serially arranged. If the client has not done so, the auditor himself is required to do so.
- 2) Vouchers which have been inspected by the auditor should be cancelled by a rubber stamp to avoid the possibility of their being produced again. Cancellation can be done with a special tickmark also.
- 3) The auditor should be careful about vouchers which are not in the name of the business but in personal name of the partners, directors, manager, secretary or any other official. It is possible that the expenses relate to that individual and not to the business. For example, the partner may have purchased a suit length for himself and shown it as uniform for the staff. The auditor should ensure that the goods purchased, should relate to the business and are duly entered in the stock register.
- 4) The auditor should ensure that every voucher has been certified as in order by a responsible officer. If the voucher is in printed form or rubber stamped by suppliers etc. these should, ordinarily be treated as genuine.
- 5) As far as possible, the work relating to a particular period or set of books should be completed at a stretch or in one sitting.

- 6) The auditor should be very careful about missing vouchers and receipts. He should make inquiries about their loss and ask for their duplicate copies.
- 7) The auditor should never take the help of clients' staff in the scrutiny and checking of vouchers.
- 8) While examining the vouchers, the auditor should ensure that they are properly entered in relevant financial books and see that capital and revenue items are correctly recorded.
- 9) As far as possible, the auditor should check each and every voucher. Test-checking should be resorted to only when internal check system in operation is reliable and satisfactory.

**In addition to general considerations mentioned above an auditor should examine the following things about each and every voucher in particular.**

- 10) The date, amount and name in whose favour a voucher has been issued should be carefully examined. It should be ensured that no voucher which does not relate to clients' business has been entered in the books.
- 11) It should be ensured that the voucher relates to the period under audit.
- 12) The amount on all vouchers should be mentioned both in words and in figures.
- 13) All receipts in excess of Rs. 20/- must have a 20 paise revenue stamp affixed to them.
- 14) All vouchers should be signed by some responsible officer on behalf of the payee.
- 15) All alterations in vouchers should bear initials of the invoice clerk.

**Check Your Progress A**

- 1) State whether the following statements are True or False.
  - a) The auditor is mainly concerned with collection and evaluation of evidences to establish accuracy and authenticity of those facts that have actually taken place.
  - b) The auditor is not at all concerned with the adequacy and reliability of evidences produced by his client.
  - c) Vouching is a method of examination to substantiate an entry in the books of account with documentary evidences, but for this, the auditor should not go beyond the books of account.
  - d) Vouching is regarded as the very essence of auditing.
  - e) While routine checking is carried out, vouching may be considered as superficial.
  - f) Routine checking cannot reveal serious discrepancies, errors of principle and carefully planned frauds.
- 2) What is a primary voucher? Give two examples.

.....

.....

.....

**4.4 VOUCHING OF CASH RECEIPTS**

Vouching of cash receipts and cash payments involve scrutiny of the debit and credit side of the Cash Book. Before commencing the work of vouching Cash Book, the auditor should satisfy himself about the existence of a reliable system of internal check as regards receipt and payment of cash. Most of the errors and frauds are committed in receipts and payments of cash. The auditor should, therefore, be very careful while checking items of cash and should ensure that no receipt or payment remains unrecorded in the Cash Book.

It has been observed that checking of cash receipts is more difficult than checking of cash payments, because there is no proof of a cash receipt which is omitted. If an outsider pays an amount, he cannot ensure its recording in the books of the receiver. He may get a receipt for it. The only proof of receipt from him, therefore, is the carbon copy of the receipt issued and this may not be prepared or the amount on it may be understated. In short, there are more chances of misappropriation of receipts than payments.

**Following points should be noted by an auditor while vouching cash receipts :**

- 1) **Existence of internal check:** The auditor should study the system of internal check in operation. If there is a good system of internal check, the work of the auditor becomes somewhat easy. The auditor, in such circumstances, can depend on test checking i.e.

checking entries for selected months or a few selected transactions at random. If he finds them in order, he can presume that others are also be correct.

- 2) **Comparing rough cash book or diary with the cash book :** Generally, there is a convention in all business houses to record all cash receipts first in a diary or rough cash book and then enter them in cash book proper. An auditor should compare the diary or the rough cash book with the cash book proper. He should ensure that all receipts noted in diary or rough cash book are promptly recorded in cash book and that there is not much time lag. If rough cash book or diary happens to be the part of accounting system in a business, the auditor can be held guilty of negligence if he fails to make the comparisons and if any fraud is detected later on.
- 3) **Proper control over use of receipt-book :** The auditor should ensure that receipt books are kept under the control of some responsible officer. All receipts should be issued on printed forms bearing serial numbers and a carbon copy of the same should be retained in the office. The auditor should compare the name of the party, the date and the amount mentioned in the receipt with those in the cash book. If there are some entries in the cash book for which receipts have not been issued, the auditor should make detailed investigations. The receipts should be signed by some responsible officer. Auditor should also see that the rate of discount allowed, if any, is uniform. He should also see whether all cash receipts are deposited in the bank daily and supported by a bank pay-in-slips.

**4.4.1 Cash Sales**

Chances of fraud are maximum in case of cash sales since the salesman may sell the goods and pocket the money. In the absence of efficient system of internal check, it is rather impossible to detect frauds of cash sales.

**Internal check regarding cash sales should provide for the following:**

- 1) Salesman should not be allowed to deliver the goods or receive payments for the goods sold.
- 2) Salesman should prepare three copies of the cash memo. One copy should be retained in the booklet, one copy should be handed over to the customer and one copy should be attached to the packet of the sold goods.
- 3) The customer should be asked to present his copy to the Cashier and make the payment to him. The cashier should put the stamp "payment received" and sign the cash memo.
- 4) The customer should be asked to present his copy of the cash memo at the delivery counter. The delivery man should keep this copy with him, put the stamp "delivered" on the third copy attached with the goods sold and deliver it to the customers.

After satisfying himself about the existence of an effective system of internal check about cash sales, the auditor **should take the following steps to vouch cash sales :**

- 1) Check the counterfoils of cash sales book with salesman's summaries or abstracts and ensure that salesman's abstracts tally with the cash receipts of the cashier.
- 2) Check details of cash received with cash memo booklets.
- 3) Compare the daily totals of the cashier's sheets of cash receipts with corresponding entries in the main cash book. Where mechanical or electronic cash registers are used, the daily totals entered in the cash book should be checked with the till rolls.

**4.4.2 Receipt from Debtors**

It is quite difficult to vouch cash receipts from debtors. The only evidence for cash received from them is the counterfoil of receipts issued to them. But this evidence is not very reliable. Fraud may be committed by entering lesser amount in the counterfoil, or by issuing receipts to debtors from the unused receipt book, or by entering less amount in the debit side of the cash book.

**In vouching receipts from debtors an auditor should take the following steps:**

- 1) Examine the internal check system in operation in this regard.
- 2) Ensure that unused receipt books are kept in the custody and control of some responsible officer.
- 3) Ensure that original copies of all the spoilt receipt forms are attached with the duplicate copies in the receipt book.

- 4) Tally dates and amounts on the counterfoils with those in the cash book.
- 5) Ensure that payments received through cheques are entered in the cash book. If there is a practice of not issuing receipts in printed form for cheques received, the auditor should check daily lists of cheques received with entries in the cash book.
- 6) Proper scrutiny should be made about discount allowed to customers. The auditors should inquire about the terms and conditions of allowing discounts and adopt test-checking to ensure whether discount allowed is in order. In many cases, misappropriations take place by inflating the discount amount or by inserting fictitious entries of discount.
- 7) Special attention should be paid to amounts written off as bad debts. There are chances that the amount from the debtors had been received and misappropriated and thereafter the debt had been written off as bad. The auditor should ensure that some only responsible officer is allowed to write off debts. The auditor, with the permission of his client, can request debtors to certify the amount outstanding against them.
- 8) Avoidance of "teeming and lading method" or "lapping"—Under teeming and lading method the cashier makes private use of money for sometime. He may receive money from debtors, but he may not make entry for receipt immediately, thus making delays in recording. For example when money is received from A, he makes no entry. When similar amount is received from another debtor B, he makes an entry in A's account and when money is received from C, he makes entry in B's account. In this way, the cashier utilises the money for sometime for his personal use. Of course, no misappropriation of money is committed as such but the cashier deprives the business of money for sometime. Lapping is the process of concealment of a shortage of money by delaying the recording of receipt of cash. The auditor can check this practice by scrutinising the debtors' accounts, especially those accounts which show part payments from time to time, although in the part such debtors have been making full payments in settling the accounts. The auditor should compare the amount deposited in the bank with the amount entered in the counterfoil of the pay-in-slip to check whether full amount has been deposited in the bank or not. To ascertain whether any money has been misappropriated or not, he should also compare the date of receipt of money and the date of its deposit in the bank. The auditor can also get the balance confirmed from the debtors.

#### 4.4.3 Sale of Investments

Business houses keep on purchasing and selling shares, debentures, Govt. bonds etc. If any investment is sold, the auditor should make sure that correct amount is received by the business. For example, if the business has sold one thousand shares of LML Ltd. The question is, how will the auditor know whether they have been sold for Rs. 1,600 as shown in the cash book, or for more? For vouching this, the auditor should see the broker's contract note and if the investments have been sold through a bank, the bank advice should be seen. There are two methods of sale of investments i.e., "cum-dividend" and "ex-dividend". In the case of cum-dividend sale the auditor should see that the dividend has not been subsequently received and that the sale proceeds have been apportioned between capital and revenue. If the investments have been sold ex-dividend, the auditor should check whether dividend has subsequently been received or not.

#### 4.4.4 Interest and Dividends

If interest has been received on fixed deposits with banks, such income should be vouched with the help of entry in the pass book for the interest received. Of course it should be seen that the pass book is not fake. If interest has been received on account of a loan given, the auditor should check the agreement made with the borrower and note the amount of loan rate of interest, etc. If interest has been received on securities, the vouching of such income can be done by obtaining a schedule of such receipts from a responsible officer of the client.

Receipt of dividend on shares can be vouched by referring to the covering letter which is generally attached with the cheque for the dividend. If the bank has been authorised to collect dividends, the amount can be verified from the pass book. The auditor should make sure that all incomes on account of interest or dividend relating to a particular year are accounted for in the books and shown in the balance sheet of that very year.

#### 4.4.5 Rent Received

The business may have let out some of its buildings to outsiders on rent. It is but natural that the rental income should be properly accounted for. For vouching income from rent the auditor should examine the lease deed or the agreement with the tenants and ascertain the amount of rent receivable, the due date of receipt etc. Rent received can also be checked from counterfoils of rent receipt issued to the tenants. If agents have been appointed to collect rent, the statements submitted by them can also be scrutinised. There is a possibility that rent might have been received but shown as outstanding. To check this, the auditor can request the tenants to confirm that they have not yet paid full rent for the current year.

#### 4.4.6 Sale of Fixed Assets

To vouch the amount received from sale of fixed assets such as land, buildings, furniture, machinery etc., the auditor should refer to the correspondence made with the purchaser. If the asset has been sold through a broker, his note should be seen. If the asset has been sold through auction, the auctioneer's note should be examined. The auditor can see the sale deed also. Profit earned on the sale of fixed asset should be credited to capital reserve and not to the general Profit and Loss Account.

#### 4.4.7 Commission Received

To vouch the money received on account of commission, the auditor should examine the agreement between the client and the party concerned, check up the rate of commission, the terms of commission, etc. The amount entered in the cash book should be compared with the counterfoils of receipts. When the commission has been received in respect of goods received on consignment, the auditor should compare the amount of commission with the copy of account sale.

### 4.5 VOUCHING OF CASH PAYMENTS

It is very important that the business should pay what it is bound to pay. There should be no bogus payments. The auditor has not only to see that payments have actually been made but also to satisfy himself that

- i) the payment made relates to the business;
- ii) it relates to that accounting year;
- iii) it has been made to the right person;
- iv) it has been properly sanctioned;
- v) it has been properly recorded;
- vi) it is supported by proper documentary evidence; and
- vii) the particulars stated in the voucher tally with those in the cash book.

While checking the genuineness of payments, the auditor should see whether the system of internal check regarding cash payments is effective or not.

Methods of vouching some important items of payments have been discussed in the following paragraphs :

#### 4.5.1 Cash Purchases

While vouching cash purchases, the auditor should see that the goods for which payment has been made are really received in the business. For this, he should :

- i) verify entries in the Goods Inward Book ;
- ii) compare entries in the cash book with cash memos ;
- iii) check that only the net amount i.e., the cost of goods purchased minus trade discount, if any, has been paid.

#### 4.5.2 Cash Paid to Creditors

Suppliers may supply raw material and other things on credit to the business, payment for which is made later on. It is the duty of the auditor to see that only the right amount is paid to the creditors and that they have actually received it. Money paid to creditors can be

vouched through receipts issued by creditors acknowledging the receipt of money. Money due to them can be ascertained by having a look at their personal accounts in the ledger and the actual invoices received from them. The auditor should inquire whether creditors are requested to furnish periodical statement showing the amount due to them and whether these are compared with their personal accounts. In order to see that the entries passed are authentic, the auditor should also check the minutes, the contracts, the correspondence and the other documentary evidences.

#### 4.5.3 Wages

Business houses have to spend large amounts in payment of wages and salaries to the staff. Many frauds have been detected in payment of wages and salaries. One of the most important duties of the auditor is to vouch wages. For this he should, first of all, assess the effectiveness of internal check system in this regard. If the system is effective, possibilities of frauds and errors get reduced to a great extent.

##### As regards wages the auditor should ensure that

- i) the wages shown as paid had actually been paid;
- ii) the wages paid were actually due to be paid (i.e., the person getting wages has actually worked for the organisation);
- iii) the calculations about amount payable are correct.

Most commonly noted methods of fraud regarding payment of wages arise due to inclusion of fictitious names or "dummy" workers in wage sheet or the inflating of time spent by workers in factory or in the case of payment under piece-rate, the inflating of number of units produced by workers, overstating rates of wages, understatement of deductions, inclusion of names of those workers in wage sheet who have resigned or whose services have been terminated.

##### While vouching payment of wages, the auditor should ensure that

- i) time spent by workers in the factory is properly recorded which can be ensured by use of time recording clocks;
- ii) where the wages are paid according to piece-rate system, proper records are maintained about the number of pieces produced by the worker, which can be done by maintaining a production card for each worker;
- iii) wage sheets should be prepared accurately which should show the name of the worker, his designation, the rate of wages, the time spent by each worker in the factory, the gross amount payable, the deductions made from wages, the wages paid in advance, etc. Wage sheets should also bear signatures or thumb impressions of the worker receiving the wages;
- iv) the auditor should ensure that actual payment of wages has been made. In no case, persons responsible for preparation of wages sheets should be associated with the actual payment of wages. The disbursement of wages should be entrusted to the cashier. The foreman of each department should be present at the time of payment to prevent impersonation. Regarding absentee workers, wages should be paid only on the basis of authority slip given by them;
- v) all officers, namely, the cashier, the foreman and the works manager should sign the wage sheets certifying it to be correct.

Problems arise in case of payment of wages to casual workers and on-the-spot payment to some contractual temporary workers. There are chances that names of dummy workers may be included and the amount shown as payment to such workers is misappropriated. To avoid this possibility, the officer authorised to hire such workers should never be associated with the making of payments to them.

##### Auditors' Duties as Regards Wages

The duties of an auditor regarding vouching of wages can be summarised as follows:

- 1) He should examine the internal check system in operation regarding preparation of wage sheets or wages book and payment of wages.
- 2) He should check totals of wage sheets or wage books.
- 3) He should check calculation of a few items of wages sheets.
- 4) He should compare the net amount of wages payable and amount of the cheque drawn for this purpose. This will ensure that money is not overdrawn.
- 5) He should check names of a few workers appearing in the wage sheets with job cards or

foreman's register, provident fund register, employees state insurance register etc. to ensure that no fictitious name has been entered in the wage sheets. The wage sheets should be initialled or signed by the person responsible for their preparation:

- 6) He should compare the sanctioned strength of workers with the number of names appearing in the wage sheets to ensure that there is no increase in the number of workers.
- 7) He should check whether there is a signature or thumb impression of the worker on wage sheets for having received the wages. To check the genuineness of the signatures of the recipient, the auditor should compare his signatures as appearing in wage sheets of two or three different months.
- 8) He should examine the system of employment of casual labour. If he finds any loopholes, a detailed investigation should be done by him.
- 9) He should check leave register to ascertain whether any worker who was on leave without pay has been paid the wages.
- 10) He may pay a surprise visit on the day of payment of wages to check whether system of internal check is working efficiently or not.

#### 4.5.4 Salaries

Remuneration paid to blue collar workers is called wages while the payment to white collar office workers is called salary. For vouching salaries paid, the auditor should check the salary register and the cash book to ensure that cheques for correct amount have been drawn. The auditor should also check calculations and deductions made in case of a few employees at random. If there is any change in the salary of an employee between two months, the reasons for the same should be looked into. It may be due to an increment or some reward or it may be a case of overpayment. The auditor can also see the counterfoils of cheque book for checking the amount of salary paid. He should see that the salary register is signed by a responsible officer. For knowing the basic salary, pay scale, the rate of increment and the date of increment, reference can be made to the appointment letter, the agreement or the minutes of the Board of Directors' meetings.

#### 4.5.5 Rent Paid

For vouching payment of rent, the auditor should check the agreement or the lease deed entered into between the owner of the building and his client. He should ensure that only correct amount is paid and there is a proper receipt for it. Rent outstanding, if any, for the current year should be taken into account. If there has to be some deduction on account of repair charges, the auditor should ensure that the same has been made. Generally, one month's rent is deductible from the annual rent if the landlord does not bear expenses on repairs.

#### 4.5.6 Capital Expenditure

Capital expenditure means money spent on purchase of fixed assets like land, buildings, plant and machinery, patents, investments etc. Such an expenditure is, normally, heavy and requires special attention. While vouching expenditure on capital items, the auditor should see that the payment is in order, it is duly authorised, the money spent is properly capitalised and the asset has been received in the business. We now take up vouching procedure for some of the fixed assets.

- a) **Purchase of Land and Buildings** : To know the purchase price of Land or Building purchased, reference can be made to auctioneers' or brokers note and of course cash receipt issued by the seller is always a good proof :

The auditor should check whether the title deed is in the name of his client. In the case of leasehold property, the terms of lease should be examined. If the building was got constructed through a contractor, the cost can be known by studying the original agreement with the contractor and by examining the architect's certificates.

- b) **Purchase of Investments** : The purchase of investments like shares, debentures, bonds etc. can be vouched with reference to broker's contract note. The proof of investments can also be in the form of share or debenture certificate or the bond. In the case of purchase of investments through bank, bank pass-book can be examined. In the case of new subscriptions, letters of allotment etc. can be seen.

- c) **Patents and Copy-rights** : Patent means a formula for producing something, for example, formula of preparing a cough mixture. Copy-right means the right to produce an item of a particular design. For vouching payments made for acquiring a patent or copy-right, the auditor can examine agreement of purchase, receipt issued by seller, etc. Expenses incurred on purchase of patent-rights etc. together with commission, if any, paid should be capitalised.
- d) **Payment under hire purchase and instalment system** : To know the purchase price, the auditor should examine the hire-purchase agreement. For monthly or periodical payments, he should see the receipts from the supplier. Where instalment includes interest also, the amount of interest should be treated as a revenue expenditure.

**4.5.7 Travelling Expenses**

While checking expenses on travelling, the auditor should ensure that the payment is for journey undertaken in connection with the business. He should check the distance travelled, the fare and the halting allowance paid. It should be ensured that the travelling expenses bills of the employees have been passed by some responsible officer of the client. The auditor should also scrutinise the receipts obtained from employees in this connection.

**4.5.8 Petty Cash**

The auditor should be careful about vouching petty expenses because, many a times, there may not be supporting vouchers for them. The auditor has to rely on the internal check system in this regard which should be satisfactory. The petty cash book should be maintained on imprest system, because under this system the main cashier gets some opportunity of examining the expenses. The auditor should do physical verification of cash in the hand of the petty cash book-keeper at the close of the year. The petty cash book should preferably be in columnar form.

The auditor should examine the totals and the balance of petty cash book. He should insist on production of vouchers if payment exceeds Rs. 5. The petty cash book should be periodically checked and initialled by some responsible officer.

**4.5.9 Postage**

For vouching expenses on postage, the auditor should compare postage book with petty cash book (or cash book if petty cash book is not maintained) and as a surprise check, count value of stamps in hand. He should ensure that postal expenses include only those expenses which are for and in connection with the business of the client. Private letters of employees should not be sent at the cost of the business.

**Check your Progress B**

- 1) State whether the following statements are True or False.
  - a) While vouching cash receipts, the auditor should study the system of internal check in operation.
  - b) Chances of fraud are maximum in the case of cash sales.
  - c) While vouching receipts from debtors, the auditor need not pay any attention to the amount of bad debts written off.
  - d) While vouching sales of fixed assets, the auditor should ensure that the profit on sale of fixed assets has been treated as revenue profit.
  - e) Fraud can be committed by inclusion of fictitious names or dummy workers in the wage sheet.
  - f) The foreman of each department should be present at the time of wage payment to prevent impersonation.
- 2) Name the documents an auditor should examine while vouching cash sales.
 

.....

.....

.....
- 3) Name the documents an auditor should examine while vouching land and building.
 

.....

.....

.....

**4.6 LET US SUM UP**

The task performed by the auditor in establishing accuracy and authenticity of the accounting entries made in the books of accounts with reference to actual evidence available are technically called "vouching". Different authors have defined vouching in various ways. If we analyse the various definitions, we can come to the conclusion that vouching is a method of examination not only to substantiate an entry in the books of account with documentary evidences, but also to see that these evidences are adequate, reliable and really connected with the business. For this, the auditor should go even beyond the books of account.

Objectives of vouching are (i) to examine the accounting entries recorded in the books of account with reference to documentary evidence, (ii) to examine the adequacy and reliability of such documentary evidences, and (iii) to examine the authenticity of the transactions recorded in the books of account.

Vouching is regarded as the very essence of auditing. It is important to note that serious discrepancies, errors of principle and clever frauds can be detected through vouching. It is only through vouching that the auditor can satisfy himself as to the accuracy, authenticity and completeness of the transactions recorded in the books of account and only then can he certify that the financial statements exhibit a true and fair view of the results of operations and state of affairs of the business. In case the auditor is found negligent in the discharge of his duties, he will be held guilty.

A voucher is a documentary evidence produced in support of each and every entry made in the books of account. The vouchers constitute the main source of evidence available to the auditor. From the auditor's point of view the vouchers are classified into three categories, namely (i) vouchers prepared outside the organisation, (ii) vouchers prepared inside the organisation, but validated by independent sources and (iii) vouchers prepared and used completely within the organisation. From the point of view of the nature of vouchers, however, vouchers are classified into (a) primary vouchers and (b) collateral vouchers. The auditor should see that the vouchers contain all the essential points. For vouching cash book transactions, the auditor should see whether the system of internal check in operation is effective and reliable. If the system of internal check is effective and reliable, the work of the auditor becomes easier. The auditor should undertake vouching of each and every item of cash receipt and cash payment with great care.

**4.7 KEY WORDS**

**Evidence in Audit** : Proof in support of the entries made in the books of account to establish their accuracy and authenticity.

**Voucher** : A documentary evidence produced in support of each and every entry made in the books of account.

**Primary Voucher** : An original voucher in writing produced in support of an entry like purchase invoice.

**Collateral Voucher** : A subsidiary voucher produced in the absence of an original voucher.

**Vouching** : Testing the truth of each and every entry made in the books of account with reference to documentary evidences.

**4.8 ANSWERS TO CHECK YOUR PROGRESS**

- A 1 (a) True, (b) False, (c) False, (d) True, (e) False, (f) True.
- B 1 (a) True, (b) True, (c) False, (d) False, (e) True, (f) True

## 4.9 TERMINAL QUESTIONS

- 1) What is meant by Vouching? What are its objectives? Explain the importance of vouching.
- 2) "Vouching is the essence of audit". Explain the statement and discuss the importance of vouching.
- 3) What is a voucher? How would you classify it? What are the special points an auditor should bear in mind while examining a voucher?
- 4) How would you vouch the following items: (a) Cash Sales, (b) Receipts from Debtors and (c) Sale of Investments.
- 5) "In vouching payments, the auditor does not merely seek proof that money has been paid away". Discuss and explain the general considerations to be borne in mind by the auditor while vouching cash transactions.
- 6) How would you vouch the following items: (a) Cash purchases, (b) Payments to Creditors, (c) Payment of Wages, (d) Travelling Expenses and (c) Petty Cash?

**Note :** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the University. These are for your practice only.

## UNIT 5 VOUCHING OF TRADING TRANSACTIONS AND IMPERSONAL LEDGER

### Structure

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Credit Purchases
- 5.3 Purchases Returns
- 5.4 Credit Sales
- 5.5 Sales Returns
- 5.6 Goods Sent on Consignment
- 5.7 Packages and Empties
- 5.8 Journal
- 5.9 Vouching of Impersonal Ledger
- 5.10 Outstanding Assets and Liabilities
  - 5.10.1 Outstanding Assets
  - 5.10.2 Outstanding Liabilities
- 5.11 Contingent Liabilities
- 5.12 Apportionment of Expenditure Between Capital and Revenue
- 5.13 Let Us Sum Up
- 5.14 Key Words
- 5.15 Answers To Check Your Progress
- 5.16 Terminal Questions

### 5.0 OBJECTIVES

After studying this unit, you should be able to :

- vouch credit sales and credit purchases
- vouch packages and empties
- vouch journal entries
- vouch outstanding assets and liabilities
- vouch contingent liabilities
- vouch capital and revenue.

### 5.1 INTRODUCTION

In Unit 26 you have learnt the meaning, definition, objectives and importance of vouching and also the process of cash receipts and payments. In this unit, we will discuss the process of vouching trading transactions which do not involve immediate movement of cash and the vouching of impersonal ledger which contain nominal and real accounts.

### 5.2 CREDIT PURCHASES

Goods purchased on credit are entered in the Purchases Book. The object of vouching credit purchases is to see that the auditor's client pays for only those goods which have been actually received in the business and that the goods are not misappropriated.

Before starting vouching of credit purchases, the auditor should examine the system of internal check in operation about purchases. If the system is ineffective he should exercise great care and exhaustively check the Purchases Book and related ledger accounts. The auditor should also make inquiries about the procedure of placing orders, receiving goods checking invoices, etc.

You will recall that a **good system of internal check about purchases should have the following salient features :**



## 4.9 TERMINAL QUESTIONS

- 1) What is meant by Vouching? What are its objectives? Explain the importance of vouching.
- 2) "Vouching is the essence of audit". Explain the statement and discuss the importance of vouching.
- 3) What is a voucher? How would you classify it? What are the special points an auditor should bear in mind while examining a voucher?
- 4) How would you vouch the following items: (a) Cash Sales, (b) Receipts from Debtors and (c) Sale of Investments.
- 5) "In vouching payments, the auditor does not merely seek proof that money has been paid away". Discuss and explain the general considerations to be borne in mind by the auditor while vouching cash transactions.
- 6) How would you vouch the following items: (a) Cash purchases, (b) Payments to Creditors, (c) Payment of Wages, (d) Travelling Expenses and (e) Petty Cash?

**Note :** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the University. These are for your practice only.

## UNIT 5 VOUCHING OF TRADING TRANSACTIONS AND IMPERSONAL LEDGER

### Structure

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Credit Purchases
- 5.3 Purchases Returns
- 5.4 Credit Sales
- 5.5 Sales Returns
- 5.6 Goods Sent on Consignment
- 5.7 Packages and Empties
- 5.8 Journal
- 5.9 Vouching of Impersonal Ledger
- 5.10 Outstanding Assets and Liabilities
  - 5.10.1 Outstanding Assets
  - 5.10.2 Outstanding Liabilities
- 5.11 Contingent Liabilities
- 5.12 Apportionment of Expenditure Between Capital and Revenue
- 5.13 Let Us Sum Up
- 5.14 Key Words
- 5.15 Answers To Check Your Progress
- 5.16 Terminal Questions

### 5.0 OBJECTIVES

After studying this unit, you should be able to :

- vouch credit sales and credit purchases
- vouch packages and empties
- vouch journal entries
- vouch outstanding assets and liabilities
- vouch contingent liabilities
- vouch capital and revenue.

### 5.1 INTRODUCTION

In Unit 26 you have learnt the meaning, definition, objectives and importance of vouching and also the process of cash receipts and payments. In this unit, we will discuss the process of vouching trading transactions which do not involve immediate movement of cash and the vouching of impersonal ledger which contain nominal and real accounts.

### 5.2 CREDIT PURCHASES

Goods purchased on credit are entered in the Purchases Book. The object of vouching credit purchases is to see that the auditor's client pays for only those goods which have been actually received in the business and that the goods are not misappropriated.

Before starting vouching of credit purchases, the auditor should examine the system of internal check in operation about purchases. If the system is ineffective he should exercise great care and exhaustively check the Purchases Book and related ledger accounts. The auditor should also make inquiries about the procedure of placing orders, receiving goods checking invoices, etc.

You will recall that a good system of internal check about purchases should have the following salient features :

- 1) All the orders for purchase of goods should be recorded in 'Purchase orders Book' and three copies of the order should be prepared. The order for purchase should be placed by some responsible officer.
- 2) On receipt of the goods, the gatekeeper or the store-keeper should record its arrival in the "Goods Inward Book".
- 3) After making entry for goods arrived in the Goods Inward Book, the quantity, quality, weight etc. of the goods should be compared with the invoices.
- 4) Some other clerk should check calculations of the invoice.
- 5) The invoice should then be sent to the head of the department placing the order who should check rates, quality and quantity of the goods.
- 6) Thereafter, the invoice may be passed on to the office assistant who will record the same in the "Purchases Book".
- 7) Every person who has processed the invoice should initial it.

After satisfying himself about the existence and adequacy of the internal check system, the auditor should then proceed with the vouching of Purchases Book.

**An auditor should note the following points while vouching the Purchases Book and the connected documents :**

- 1) He should check whether the invoices are in order, for which he should see that:
  - a) these are in the name of his client;
  - b) they relate to the period under audit;
  - c) they relate to the business of client;
  - d) these are initialled by all persons who checked and processed them;
  - e) usual trade discount has been deducted from the gross amount; and
  - f) these have been entered in Purchases Book and the names of sellers are properly recorded in it;
- 2) Goods received have been duly entered in the Goods Inward Book.
- 3) To avoid the possibility of suppressing amount of purchases the auditor should compare the figures in the Goods Inward Book, the Stock Register, and the Purchases Book. The quantity and value of goods in all these three books should be the same.
- 4) Capital purchases, like purchase of machinery, furniture etc. should not be entered in the Purchases Book. Only revenue purchases should be entered in it.
- 5) No invoice should be entered twice in the books. The auditor should stamp or cancel the checked invoices.
- 6) Totals and balances of Purchases Book and postings to ledger accounts should be thoroughly checked.
- 7) If any purchase is not supported by a voucher, the auditor should ask for a duplicate copy of the invoice.
- 8) If it runs into many pages, the totals of each page of invoice should be separately checked.

### 5.3 PURCHASES RETURNS

Many a times, goods are returned to the suppliers if those are defective, inferior or not as per the order. The value of such returned goods should be received back from the supplier or adjusted against future payments. After return of goods a copy of Debit Note should be sent to Cash Section for payment of net amount to the supplier. If the payment has already been made to the supplier, a Credit Note should be obtained from the supplier.

The auditor should compare the credit note with entries in the Purchases Return Book or the stores record so as to ensure that no bogus returns are shown. The auditor should also examine the system of internal check regarding purchases returns. He should check the totals in the Purchases Returns Books and the postings in ledger accounts.

### 5.4 CREDIT SALES

Goods sold on credit are entered in the Sales Book. The auditor should be careful while vouching credit sales as the documentary evidence in this case is not as conclusive as in the case of credit purchases. First of all, the auditor should examine the system of internal check regarding credit sales.

You will recall that a good system of internal check regarding credit sales should have the following features :

- 1) On receipt of the order, an entry should be made in the Orders Received Book, giving full particulars regarding the date, the name of the purchaser, the goods ordered, and the date of delivery etc.
- 2) A copy of the order should be sent to the Despatch Department.
- 3) When the goods are being despatched, another clerk should compare the details of the goods being packed to ensure that order has been properly complied with.
- 4) Some responsible officer should mark the rates in the invoices being sent.
- 5) The invoice should be prepared in duplicate or triplicate. One copy of it should be sent to the invoice clerk who should make an entry in the Sales Book, this copy should later on be sent to the customer. Another copy of the invoice should be sent to the gate-keeper who will make entry in Goods Outward Book. The third copy will be retained for record purposes.

**An auditor should note the following points while vouching credit sales :**

- 1) He should compare the date, the name of the purchaser, the quantity and the amount of the goods mentioned in the invoice with the particulars given in the Sales Book.
- 2) Entries in Sales Book should be compared with Orders Received Book and Goods Outwards Book to make sure that no sales go unrecorded.
- 3) The cancelled invoices, if any, should be checked with their duplicate copies.
- 4) There should be no discrepancy in the rate of discount allowed to different customers. If there is any discrepancy, the reason for the same should be inquired into.
- 5) If the goods have been sold on "approval basis", it should not be treated as sales unless the approval letter has been received from the customer.
- 6) The auditor should pay particular attention to sales relating to the period in the beginning or at the end of the accounting year. This is to make sure that no manipulations have been made in the accounts to inflate sales.
- 7) The auditor should check castings and postings of Sales Book.
- 8) The auditor should ensure that the sale of capital items like old machinery, old furniture etc. is not entered in the Sales Book.
- 9) With the permission of the client, the auditor can get the outstanding balance of the customers duly confirmed from them. This may be done at least in some cases as a test check.

### 5.5 SALES RETURNS

If customers find that goods are defective or are not as per the order, they return them to the supplier. On receipt of such goods an entry should be made in the Return Inward Book by the gate-keeper and, by a clerk, in the Stock Register. An entry should also be made in Sales Returns Book. A credit note, duly signed by a responsible officer, should be sent to the customer. The auditor can vouch sales returns by comparing entries in gate-keeper's Returns Inwards Book and the carbon copies of credit notes sent to the customers. The auditor should ensure that all goods returned by customers are recorded in both the Stock Register and the Sales Returns Book. If this is not done, the stock and sales will get inflated and the business will show fictitious profit.

The auditor should carefully examine the internal check system in operation regarding sales returns. He should specially check a few entries in the Sales Returns Book relating to the beginning and the end of the year. He should check a few castings of Sales Return Book and the postings in ledger accounts.

### 5.6 GOODS SENT ON CONSIGNMENT

When goods are sent to various agents at different cities for sale on commission basis, these are called 'goods sent on consignment'. The agents hold the goods on behalf of the principal at his risk. Merely sending of goods to agents cannot be termed as sales. Sale will take place when agents actually sell the goods. When goods are sent on consignment, an entry should be made in 'Consignment Outward Journal'. Entries in this journal can be vouched with the help of the amount shown in the proforma invoice, correspondence with the agents, the consignment accounts of different agents, the account sales furnished by the agents and the

contracts with the agents. Unsold goods lying with agents should be shown on the credit side of the Trading Account as well as in the Balance sheet as 'Stock on consignment'. The stock on consignment should be valued at cost or market price, whichever is lower. If the goods have been sent to agents at more than cost i.e. at proforma invoice price, the necessary consignment stock reserve should be created. Provision should also be made for any loss likely to arise in future.

### 5.7 PACKAGES AND EMPTIES

Many a times, sellers send goods to customers in packages like bottles, casks, cylinders, drums, crates, cans which are returnable. You might notice that cold drink bottles are returnable to sodawater companies. It is but natural that accurate accounts should be kept about containers or packages supplied to buyers and returned by them. It is better to maintain a separate "Packages and Empties Account" in the sales journal. This account should be debited when new empties are purchased. The customers' account should be debited and packages and empties account be credited when these are supplied to customers. When the customers return the empties Packages and Empties Account should be debited and the customers Account be credited. Some people do not desire to keep packages and empties account as part of regular system of accounting they want to keep it in memorandum form. They feel that the cost of empties should not be included in the sales. There should be a separate Memorandum account for the empties going out and the empties being returned.

The value of empties in the hands of customers should be deducted from sales and such stock should be shown at cost less depreciation, on the asset side of the Balance Sheet. The auditor should see that proper provision is made for depreciation in respect of empties and packages in hand as well as with customers.

### 5.8 JOURNAL

Entries which cannot be passed through any other book of original or prime entry, are passed through the journal. In the absence of any special subsidiary book for recording transactions of a particular nature the entries for such transactions can also be passed through the journal. For example, if there is no separate Bills Receivable or Bills Payable Book, all entries relating to the bills of exchange will be passed through the journal.

Following transactions are usually passed through the journal:

- i) Opening and closing entries
- ii) Adjusting entries like making provision for depreciation, bad debts, rectification of errors, etc.
- iii) Entries regarding issue, allotment and forfeiture of shares.
- iv) Entries for purchase of assets on credit

The auditor should be careful while vouching the journal entries as they can be used to commit frauds. For example, good debts may be written off as bad and when cash is received from debtors in discharge of their debt, the same may be misappropriated.

**While vouching journal the auditor should ensure that :**

- i) every journal entry has a narration;
- ii) the transaction has been authorised by some responsible officer; and
- iii) the transaction is supported by documentary evidence.

Documentary evidence can be in different forms for different kinds of transactions. For opening entries, it may be previous year's Balance Sheet. For issue and allotment of shares, it may be the relevant minutes of the Board of Directors and the Prospectus.

An acquisition of assets from the vendor may be supported by a contract entered into with him. For making provisions for bad and doubtful debts, there must be some uniform procedure about which the auditor should make necessary inquiries. Bad debts should be written off under proper authority. Outstanding expenses, prepaid expenses, and accrued incomes should be properly verified. Preferably, a schedule for these items should be obtained from some responsible officer of the client.

### Check Your Progress A

- 1) State whether the following statements are True or False.
  - a) While checking a purchase invoice, the auditor should make sure that it related to the business of his client and also to the period under audit.
  - b) While vouching purchases returns, the auditor need not insist on production of debit/credit note.
  - c) While vouching credit sales, the auditor should ensure that goods sent to customers for sale on approval basis have been included in sales.
  - d) While vouching sales returns, the auditor should see to it that a credit note duly signed by a responsible officer has been sent to the customer.
  - e) While vouching goods sent on consignment, the auditor should ensure that unsold stock lying with the consignee has not been shown as an asset in the Balance Sheet.
  - f) While vouching journal, the auditor should see to it that bad debts have been written off under proper authority.
- 2) List the entries which are usually recorded in the journal.

.....

.....

.....

.....

### 5.9 VOUCHING OF IMPERSONAL LEDGER

Impersonal ledger contains two kinds of accounts viz., (i) nominal accounts like rent, salaries, cartage etc. and (ii) real accounts like machinery, furniture etc. You know that balances of nominal accounts are transferred to Trading and Profit and Loss Account while balances of real accounts are shown in the Balance Sheet. We will now study the vouching of items which appear in the impersonal ledger and relate to Profit and Loss Account.

**The Impersonal Ledger will be Vouched as Follows :**

- 1 The auditor should check postings of various cash payments and receipts in respect of nominal accounts in the impersonal ledger. These transactions can be salaries, wages, rent, etc. paid in cash or dividends, interest, etc. received in cash.
- 2 The auditor should check the totals of all the subsidiary books, and their postings in the relevant nominal accounts in the impersonal ledger.
- 3 In the case of transfer and adjustment entries from one impersonal account to another which have been passed through the journal, the auditor should see that every entry is supported by sufficient documentary evidence.
- 4 The auditor should check various adjustment entries made at the end of the year when final accounts are prepared. Such adjustments relate to outstanding assets and liabilities and depreciation etc.

### 5.10 OUTSTANDING ASSETS AND LIABILITIES

Arithmetical accuracy of impersonal ledger is no proof that the profit or loss has been correctly arrived at. If we omit certain expenses which have become due but have remained unpaid, the profit shown will be more. It is, therefore, necessary that all the expenses which have been incurred during the current year must be debited to Profit and Loss Account and shown as a liability in the Balance Sheet. Similarly, there may be certain incomes which might have accrued in the current year but not yet received. To ascertain the profits correctly, such incomes should be credited to the Profit and Loss Account and shown as an asset in the Balance Sheet.

It is advisable that a 'Memorandum Book' containing details of outstanding assets and liabilities is maintained. This book should be signed by a responsible officer. With the help of this book, the auditor can easily ascertain the outstanding and accrued items for which the adjusting entries should have been passed. Through this book, the auditor can compare outstanding and accruals of two different periods.

We will now discuss some of the outstanding assets and liabilities and the auditors duties about them.

### 5.10.1 Outstanding Assets

An expenditure which has been incurred during the current year but the benefit of which will be enjoyed during the next year is called an outstanding asset. Outstanding assets can be of three types. These are: (1) prepaid expenses, (2) incomes receivable (accrued incomes), and (3) deferred revenue expenditure.

Let us now study the nature of each item and how they shall be vouched.

1) **Prepaid Expenses:** Prepaid expenses are those expenses which have been paid in the current year but the benefit of which will be received in the forthcoming year. For example, if we pay an insurance premium of Rs. 12,000 for one year on 1st April, 1989, then one-fourth of this expenditure (Rs. 3,000) relates to the next year (from January to March 1990). Thus, Rs. 3,000 should not be charged to the Profit and Loss Account of the year 1989. If we do so, the profits for 1989 will unjustifiably get reduced by Rs. 3,000. To arrive at correct profit for the current year this amount of Rs. 3,000 should be deducted from total expenditure. Examples of prepaid expenses are: insurance premium, rent, rates and taxes, telephone bills, etc., which are generally paid in advance.

For vouching the prepaid expenses, the auditor should scrutinise the relevant nominal accounts, the demand notes, the relevant receipts, etc. and make sure that proper adjustments have been made in the account books. He should ensure that calculations in respect of prepaid expenses are correct.

2) **Incomes Receivable or Accrued Incomes:** These are incomes earned or accrued or become due in the current year but not yet received. For example, till the end of the year on 31st December, rent for December might not have been received. Similarly, a borrower of a loan might not have paid interest for the last three months of the accounting year. As these incomes have accrued in the current year, it is but natural that such incomes should be credited to current year's Profit and Loss Account. About such incomes, the auditor should make sure that they will be duly received, and that the calculations are correct.

3) **Deferred Revenue Expenditure:** According to Prof. Arnold Johnson deferred revenue expenditures are those "non-recurring expenditures which are expected to be of financial benefits to several accounting periods of indeterminable total length". The benefit of deferred revenue expenditure is likely to be enjoyed not only in the current year but also in some more years to come. Examples of such expenditures are heavy expenses on special advertisement campaign for introducing a new product, research and development expenditure, heavy expenditure on repairs of machinery, discount allowed on issue of shares, etc.

Full amount of such expenditure is not debited to the Profit and Loss Account for the year in which it is incurred. On the other hand, it is spread over the number of years during which the benefit is likely to be enjoyed and only a proportionate amount is debited to the Profit and Loss Account. For example, if Rs. 40,000 have been spent on heavy repairs to a machine which will continue to be useful for coming four years, every year 1/4 of Rs. 40,000 i.e., Rs. 10,000 should be debited to the Profit and Loss Account.

For vouching deferred revenue expenditures, the auditor should check the details of computation of the amount carried forward and see that the charge made to current year's Profit and Loss Account is reasonable. He should scrutinise the basis on which the estimates have been prepared and satisfy himself that these are reasonable.

### 5.10.2 Outstanding Liabilities

The expenses which have become due for payment and should have been paid during the current year but have not been actually paid are called 'outstanding liabilities'. For example, the rent of the building for the month of December, 1990, should have been paid during the year 1990, but has not actually been paid during the same period. Since rent for the month of December, 1990 relates to the accounting year 1990, it must be debited to the Profit and Loss Account and shown as a liability in the Balance Sheet. If outstanding liabilities are not charged to the Profit and Loss Accounts, the final account will not show the correct amount of profit or loss, and the Balance Sheet will also be erroneous. It is the duty of the auditor to verify all items of outstanding liabilities. If he fails to do so, he will be held liable for

negligence as was held in the case of Westminster Road Construction and Engineering Company Ltd.

Ascertaining all outstanding liabilities is a bit difficult task for the auditor because some items may have been suppressed or may not be clear from books of accounts. Experience of the auditor can be the main guide in such circumstances. He can find these liabilities by inspecting the payment side of the Cash Book of a few months after the close of the financial year. If he finds entry for payment of rent for December last, he can presume that it was outstanding at the close of the year. The auditor can ask some responsible officer to furnish a certificate stating that no expense relating to current year remains unpaid and the expenses which have not been paid, have been properly accounted for.

The auditor should himself scrutinise various nominal accounts like wages and salaries, rent interest, discount, taxes, etc., and compare them with figures of the last year. If the difference is large the matter should be investigated further. Following are some of the outstanding liabilities:

1) **Incomes received in advance:** It refers to that income which has been received in the current year by way of an advance, but relates to the next year. For example, a tenant may pay advance rent in the current year for January. This rent, no doubt, has been received in the current year, but it relates to the next year and hence it should not be credited to the current year's Profit and Loss Account.

The auditor should carefully scrutinise such items and ensure that all receipts which pertain to the next year should be treated as unearned income and are shown as a liability in the Balance Sheet.

2) **Unpaid or outstanding expenses:** Expenses which pertain to the current year and should have been paid but have not actually been paid during the same year are called unpaid or 'outstanding expenses'. All such expenses should be charged to the current year's Profit and Loss Account and shown as a liability in the Balance Sheet. To find out the outstanding expenses, the auditor should examine all nominal accounts, receipts, invoices, demand notes, etc. He should ensure that these have been charged to Profit and Loss Account and shown as a liability in the Balance Sheet.

3) **Purchases made at the close of the year:** Many a times, it happens that purchases made at the close of the year are received and entered in the stock register, but no entry is made in the Purchases Book with the result that purchases are understated and profit gets inflated. The auditor should call for a schedule of such purchases and ensure that Purchases Account is debited with their total amount and the amount is shown as a liability in the Balance Sheet. To check unrecorded purchases, the auditor should compare Goods Inwards Book with Purchases Book for few days before the close of the year.

4) **Outstanding Rent, Rates and Taxes:** If rent, rates and other taxes relating to the current year have not been paid by the time the books are closed, these must be ascertained and debited to the Profit and Loss Account and shown as a liability in the Balance Sheet. Failure to do so will inflate the profit for the current year. The auditor should inspect the ledger accounts, the demand notes, the receipts, etc. in order to ascertain such outstanding expenses. He can also make comparison of the current year's figures of the preceding years to assess the amounts payable.

5) **Outstanding Wages and Salaries:** It so happens that accounts are closed on the last day of the last month of the year but the wages and salaries for that month are paid on the first day of the next month in the next year. For example, the accounts may be closed on 31st March but the wages and salaries for March may be paid on 1st April. If this is done, current year's Profit and Loss Account will be debited with wages and salaries for eleven months and not twelve months. The profit revealed by Profit and Loss Account will thus get inflated. Hence, it is necessary to include the wages and salaries for March while debiting this item to the current year's Profit and Loss Account and to show wages and salaries for March in the Balance Sheet as a liability.

6) **Audit Fee:** There are two opinions on showing audit fee for auditing current year's accounts as an outstanding liability. Some say it should not be shown as current year's

expenditure because the audit work of current year's account is done in the next year and so it is next year's expense. Others say that audit fee is paid for the work of the current year and hence, it should be charged to the current year's Profit and Loss Account and shown as a liability in the Balance Sheet. Both these arguments appear to be sound. Now it is an accepted principle that if the audit work starts in the current year the audit fee should be debited to Profit and Loss Account of the current year and if the audit work commences in the succeeding year, the audit fee should be charged to that year and not shown as an outstanding liability of the current year.

- 7) **Other Liabilities:** There can be various other outstanding liabilities for expenses like freight and carriage, travellers' and agents' commission, etc. The treatment of these liabilities should be the same as that of the outstanding wages and salaries, if the expenses relate to the current accounting year these must be debited to the Profit and Loss Account of the current year, whether they have been paid or not.

### 5.11 CONTINGENT LIABILITIES

These are liabilities which are not real liabilities as on the date of the Balance Sheet but which may arise in future depending upon the happening of some future events. A contingent liability has been defined as "a possible future liability arising from one or more business acts preceding the date of the Balance Sheet". Prof. Walter B. Meigs says, *Contingent liabilities may be defined as potential obligation which may in the future develop into actual liabilities or may dissolve without necessitating any outlay.* The difference between absolute liability and contingent liability is that an absolute liability is sure to arise, but a contingent liability may or may not arise. Example of contingent liability is a bill receivable discounted with the bank which may be converted into a real liability, if the acceptor of the bill fails to pay on the due date when presented by the Bank. Similarly, a customer might have filed a suit against the business for supply of defective goods. If the judgement goes against the business it will be required to pay damages to the customer and then it will become a real liability. Thus, a pending suit for damages is a contingent liability. Other contingent liabilities can arise in case of partly paid shares, a contracts of guarantee, an unfinished contract, or for a forward contract.

**Auditor's duties regarding contingent liabilities:** The first duty of the auditor in this regard is to make sure that all contingent liabilities have been taken into account by his client. For contingent liability arising out of pending suits, the auditor should consult the solicitor of his client to know the value and genuinness of such liabilities. To know about contingent liability regarding discounted bills receivable, the auditor should make inquiries from discounting bank about number of discounted bills which have not matured yet. About liability for calls on partly paid shares the auditor should make inquiry about shares held by his client on which calls have become due or are likely to become due in the near future. About liability arising out of suretyship contracts, the auditor should examine amounts guaranteed by his client and inquire about the financial position of the principal debtors. The auditor should see that the requirements of the Companies Act regarding contingent liability have been fully complied with.

### 5.12 APPORTIONMENT OF EXPENDITURE BETWEEN CAPITAL AND REVENUE

Expenditures incurred in business can broadly be divided into two categories: (i) **capital expenditure**, and (ii) **revenue expenditure**.

A **capital expenditure** generally involves a large amount and is spent on acquiring long term assets. Its benefit is likely to be derived by business not only in the year in which the expenditure is incurred but over a fairly long period, Such expenditures increase the earning capacity of the business.

A **revenue expenditure** is one which has to be incurred as a matter of routine and its benefit is derived only in that year in which it is incurred. Purchases, rent, carriage are examples of revenue expenditure.

Wages paid for installation of a new machinery is a capital expenditure while wages paid for production of goods is a revenue expenditure.

All revenue expenditures are charged to the Profit and Loss Account and all capital expenditures are shown in the Balance Sheet as assets. It is, therefore, very important for arriving at the correct amount of Profit or Loss that all business expenditures are correctly apportioned between capital and revenue. If on account of wrong allocation, more profits are distributed among shareholders of the company, the auditor might be held responsible for the payment of dividend out of capital.

#### Check Your Progress B

- 1) State whether the following statements are True or False.
  - a) Prepaid expenses are those expenses which have been paid in the current financial year but the benefit of which will be enjoyed in the forthcoming year.
  - b) Accrued incomes are those incomes which have been received in the current year but not yet earned.
  - c) The benefit of deferred revenue expenditure is likely to be enjoyed not only in the current year but in some more years to come.
  - d) Outstanding expenses do not pertain to the current year though have actually been paid during the current year.
  - e) Contingent liabilities are not real liabilities as on the date of Balance Sheet.
  - f) Capital expenditures imply acquisition of assets.

- 2) What is a contingent liability?

.....

.....

.....

### 5.13 LET US SUM UP

Trading transactions refer to those transactions which do not involve movement of cash such as credit purchases, purchases returns, credit sales, sales returns, goods sent on consignment, etc. The vouching of such transactions involves scrutinising the efficacy of the internal check system to be followed by the client in respect of these items and examining the relevant vouchers, correspondence, etc.

While vouching the credit purchases and purchases returns, the auditors have to carefully examine the invoices, the credit notes and the Goods Received Books, and ensure that correct entries have been made in the Purchases Book. Similarly, while vouching the credit sales and sales returns, he must examine the orders Received Book, the Invoice Book, the Goods Outwards Book and the Sales Book.

With regard to goods sent on consignment, packages and empties, etc. the auditor has a special duty. He has to ensure that the stock with consignees and the packages and empties returned by customers are properly accounted for.

Impersonal Ledger contains all nominal and real accounts. The auditor has to ensure that every entry in the Impersonal Ledger is supported by a documentary evidence.

The outstanding assets refer to the prepaid expenses, accrued incomes and the unwritten off amounts of deferred revenue expenditure. The auditor must ensure that their amounts are duly adjusted in the Profit and Loss Account and shown in the Balance Sheet. Similarly, the outstanding liabilities like outstanding expenses and unearned incomes are properly adjusted in the relevant items while showing them in the Profit and Loss Account and that they appear in the Balance Sheet as liabilities.

Contingent liabilities refer to liabilities like pending suit for damages, amount uncalled on partly paid shares, and bills discounted with the bank. Where the amounts of such liabilities can be ascertained, the necessary provision must be made by debiting the Profit & Loss Account. Otherwise, they should be shown in the form of a note appended to the Balance Sheet.

The auditor must also ensure that no capital expenditure is treated as revenue expenditure.

and that all revenue expenditures are duly shown in the Profit and Loss Account. He should take special care in vouching the capital expenditure for which he may examine the relevant correspondence and contracts.

### 5.14 KEY WORDS

**Purchase Invoice :** Document containing description of goods purchased, quantity, rate, amount payable, name of the supplier, etc.

**Sales Invoice :** Document containing description of goods sold, quantity, rate, amount receivable, name of the customer, etc.

**Debit Note :** Document authorising deduction of amount from the amount payable to the supplier for goods returned.

**Credit Note :** Document authorising deduction of amount from the amount receivable from the customer for goods returned.

**Pro-forma Invoice :** Document sent to the consignee along with goods showing description of goods, quantity, price, etc.

### 5.15 ANSWERS TO CHECK YOUR PROGRESS

A 1 (a) True, (b) False, (c) False, (d) True, (e) False, (f) True.

B 1 (a) True, (b) False, (c) True, (d) False, (e) True (f) True.

### 5.16 TERMINAL QUESTIONS

- 1) Set out in detail how you would verify the items in the Bought Ledger of a trading concern.
- 2) How would you audit the Sales Book and Sales Returns Book.
- 3) What do you understand by "outstanding assets" and "outstanding liabilities"? What are the duties of an auditor in relation to outstanding liabilities?
- 4) "An audit implies more than ascertaining the arithmetical accuracy of books of accounts". Comment on this and set out ten debit items of the Profit and Loss Account stating the sources from which accuracy of the charges can be verified.
- 5) Write short notes on the following :
  - a) Vouching of contingent liabilities.
  - b) Auditor's duties regarding verification of deferred revenue expenditure.
  - c) Auditor's duties regarding verification of the apportionment of expenditure between capital and revenue.
  - d) Vouching of packages and empties.

**Note:** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the University. These are for your practice only.

## UNIT 6 VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES I

### Structure

- 6.0 Objectives
- 6.1 Introduction
- 6.2 Verification
  - 6.2.1 Meaning
  - 6.2.2 Purpose
  - 6.2.3 Process
- 6.3 Valuation of Assets
  - 6.3.1 Basis of Valuation
  - 6.3.2 Effect on Profits
  - 6.3.3 Modes of Valuation
  - 6.3.4 Auditor's Position in Respect of Valuation of Assets
- 6.4 Verification and Valuation of Specific Assets
  - 6.4.1 Goodwill
  - 6.4.2 Freehold Property
  - 6.4.3 Leasehold Property
  - 6.4.4 Plant and Machinery
  - 6.4.5 Furniture and Fixtures
  - 6.4.6 Motor Vehicles
  - 6.4.7 Patents
  - 6.4.8 Trade Marks and Copyrights
  - 6.4.9 Assets Acquired and Hire Purchase
- 6.5 Let Us Sum Up
- 6.6 Key Words
- 6.7 Answers to Check Your Progress
- 6.8 Terminal Questions

### 6.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the meaning and importance of verification in auditing
- appreciate the methods of valuation applied to different types of assets
- outline the responsibilities of auditors in respect of verification and valuation
- apply the principal considerations in verification and valuation of various fixed assets.

### 6.1 INTRODUCTION

We have now reached a stage in the study of auditing where some practical considerations seem to be essential to achieve our objectives of audit. You must have established by now that the entire audit exercise is meant to examine the correctness of the books of account and to get a report from the auditors that the financial statements of the company show a true and fair view of the state of affairs of the business for the period under review. In order to achieve this purpose of audit, however, the auditor has to apply some checks and tests. The technique of verification and valuation is one of those checks through which the auditor examines the correctness of the Balance Sheet of the company i.e., the correctness of the assets and liabilities appearing in the Balance Sheet. This is a process to ensure whether the assets and liabilities as shown in the Balance Sheet are correct in items as well as in their figures, and that all assets and liabilities of the company as on the date of the Balance Sheet have been properly included therein. If it is not so, the auditor has to get the mistakes rectified before he signs those documents, or has to state clearly in his report about the areas of dissatisfaction in the Balance Sheet.

In this unit we shall discuss the process of verification and different methods of valuation of fixed assets and auditor's responsibility thereto.

and that all revenue expenditures are duly shown in the Profit and Loss Account. He should take special care in vouching the capital expenditure for which he may examine the relevant correspondence and contracts.

### 5.14 KEY WORDS

**Purchase Invoice :** Document containing description of goods purchased, quantity, rate, amount payable, name of the supplier, etc.

**Sales Invoice :** Document containing description of goods sold, quantity, rate, amount receivable, name of the customer, etc.

**Debit Note :** Document authorising deduction of amount from the amount payable to the supplier for goods returned.

**Credit Note :** Document authorising deduction of amount from the amount receivable from the customer for goods returned.

**Pro-forma Invoice :** Document sent to the consignee along with goods showing description of goods, quantity, price, etc.

### 5.15 ANSWERS TO CHECK YOUR PROGRESS

A 1 (a) True, (b) False, (c) False, (d) True, (e) False, (f) True.

B 1 (a) True, (b) False, (c) True, (d) False, (e) True (f) True.

### 5.16 TERMINAL QUESTIONS

- 1) Set out in detail how you would verify the items in the Bought Ledger of a trading concern.
- 2) How would you audit the Sales Book and Sales Returns Book.
- 3) What do you understand by "outstanding assets" and "outstanding liabilities"? What are the duties of an auditor in relation to outstanding liabilities?
- 4) "An audit implies more than ascertaining the arithmetical accuracy of books of accounts". Comment on this and set out ten debit items of the Profit and Loss Account stating the sources from which accuracy of the charges can be verified.
- 5) Write short notes on the following :
  - a) Vouching of contingent liabilities.
  - b) Auditor's duties regarding verification of deferred revenue expenditure.
  - c) Auditor's duties regarding verification of the apportionment of expenditure between capital and revenue.
  - d) Vouching of packages and empties.

**Note:** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the University. These are for your practice only.

## UNIT 6 VERIFICATION AND VALUATION OF ASSETS AND LIABILITIES I

### Structure

- 6.0 Objectives
- 6.1 Introduction
- 6.2 Verification
  - 6.2.1 Meaning
  - 6.2.2 Purpose
  - 6.2.3 Process
- 6.3 Valuation of Assets
  - 6.3.1 Basis of Valuation
  - 6.3.2 Effect on Profits
  - 6.3.3 Modes of Valuation
  - 6.3.4 Auditor's Position in Respect of Valuation of Assets
- 6.4 Verification and Valuation of Specific Assets
  - 6.4.1 Goodwill
  - 6.4.2 Freehold Property
  - 6.4.3 Leasehold Property
  - 6.4.4 Plant and Machinery
  - 6.4.5 Furniture and Fixtures
  - 6.4.6 Motor Vehicles
  - 6.4.7 Patents
  - 6.4.8 Trade Marks and Copyrights
  - 6.4.9 Assets Acquired and Hire Purchase
- 6.5 Let Us Sum Up
- 6.6 Key Words
- 6.7 Answers to Check Your Progress
- 6.8 Terminal Questions

### 6.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the meaning and importance of verification in auditing
- appreciate the methods of valuation applied to different types of assets
- outline the responsibilities of auditors in respect of verification and valuation
- apply the principal considerations in verification and valuation of various fixed assets.

### 6.1 INTRODUCTION

We have now reached a stage in the study of auditing where some practical considerations seem to be essential to achieve our objectives of audit. You must have established by now that the entire audit exercise is meant to examine the correctness of the books of account and to get a report from the auditors that the financial statements of the company show a true and fair view of the state of affairs of the business for the period under review. In order to achieve this purpose of audit, however, the auditor has to apply some checks and tests. The technique of verification and valuation is one of those checks through which the auditor examines the correctness of the Balance Sheet of the company i.e., the correctness of the assets and liabilities appearing in the Balance Sheet. This is a process to ensure whether the assets and liabilities as shown in the Balance Sheet are correct in items as well as in their figures, and that all assets and liabilities of the company as on the date of the Balance Sheet have been properly included therein. If it is not so, the auditor has to get the mistakes rectified before he signs those documents, or has to state clearly in his report about the areas of dissatisfaction in the Balance Sheet.

In this unit we shall discuss the process of verification and different methods of valuation of fixed assets and auditor's responsibility thereto.

## 6.2 VERIFICATION

### 6.2.1 Meaning

One of the most common processes of auditing is verification and valuation of assets and liabilities. It is by the application of this process that the auditor can ascertain whether the Balance Sheet properly represents the position of the company with regard to its assets and liabilities. It is a method to satisfy with the help of inspection and documentary evidence whether the different items appearing in the Balance Sheet are at correct figures. It is an examination by the auditor to substantiate the accuracy of the Balance Sheet. The major areas of verification are existence, value and authority for acquisition of assets.

### 6.2.2 Purpose

You know it very well that it is one thing to record a transaction in the books of account. It, however, needs proper evidence to satisfy that the transaction is correct and it has been rightly represented in the final accounts. In other words, even after an entry has been checked and found correct, the possibilities of errors or frauds in final accounts cannot be ruled out. In other words, the correctness of the Balance Sheet, which is based on the balances of a number of ledger accounts, needs a careful verification. One of the usual methods of audit examination is vouching. You know that vouching is done to ensure that an expenditure has actually been incurred and that it has been correctly recorded in the books. But even after the vouching of an expenditure, assets still deserve a physical verification.

The purpose of verification, therefore, is to examine the existence, ownership, possession and valuation of assets. An asset may appear in the Balance Sheet of the company. But this does not automatically guarantee that the money paid for an asset has actually brought it into the business. Even if an asset has been included in the Balance Sheet, the risk is that :

- a) it does not exist at all,
- b) it exists but is owned by somebody else,
- c) it is owned by the company, but is in the possession of someone else, or
- d) it exists and is owned by the company, but has not been shown at correct value.

### 6.2.3 Process

Verification is an integral part of the audit of Balance Sheet. It is one of the fundamental duties of the auditor to verify the assets and liabilities as appearing in the Balance Sheet. The auditor wants to satisfy himself that the various items shown in the Balance Sheet are in order as regards their existence, ownership and value. It is an enquiry and a process of confirmation. Even if an asset is properly acquired, the auditor has still to verify that as on the date of the Balance Sheet: (i) the asset was not sold to another party, or (ii) it was not pledged or mortgaged outside the business. In particular, the areas of enquiry in course of verification of assets are :

- 1) Is there any reliable and relevant evidence to prove that the asset is owned by the company?
- 2) Does the asset physically exist at the date of the Balance Sheet?
- 3) Is the basis and principle of valuation of asset used by the company give it a correct figure?
- 4) Has the company followed the disclosure requirements in showing the asset in the Balance Sheet?

Thus the process of verification of assets is virtually a process of their confirmation. It is done with the help of documentary and other evidences. The idea is to verify the following :

- 1) **Existence:** That the assets actually existed on the date of the Balance Sheet.
- 2) **Acquisition:** That it was a duly authorised acquisition for the purposes of the business.
- 3) **Ownership:** That the assets are legally owned by the company.
- 4) **Charges:** That the assets are free from any lien, charges or encumbrances.
- 5) **Valuation:** That the assets have been correctly valued on the basis of their current condition.
- 6) **Disclosure:** That the value of the assets has been correctly disclosed in the Balance Sheet.

As regards the verification of liabilities, however, the auditor wants to ensure that: (a) all liabilities of the company on the date of its Balance Sheet have been included, (b) they have been shown at proper figures, and (c) no liability has been omitted.

In brief, the process of verification is often identified by the code VET, i.e. checking the VALUE, EXISTENCE and TITLE of the assets.

### Check Your Progress A

- 1) What is Verification?  
.....  
.....  
.....
- 2) What is Valuation?  
.....  
.....  
.....
- 3) How can you ensure that a Balance Sheet is correct?  
.....  
.....  
.....
- 4) What is the purpose of verification of physical existence of assets?  
.....  
.....  
.....
- 5) State whether the following statements are True or False.
  - i) Vouching and verification are the same.
  - ii) If an asset is purchased by a company, it is necessarily owned by the company.
  - iii) An asset which is owned by a company need not necessarily be in its possession.
  - iv) An invoice is a reliable and relevant evidence that the asset is owned by the company and it must be included in the Balance Sheet.
  - v) Depreciation must be charged to determine the true value of an asset.
  - vi) Verification of liabilities means that the amount of sundry creditors shown in the Balance Sheet is correct.

## 6.3 VALUATION OF ASSETS

You have seen earlier that one of the major aspects of verification is valuation. It is particularly in respect of assets. Assets are shown on the right hand side of a Balance Sheet. There are different types of assets and each one has its own purpose and utility. Moreover, the nature of the business also governs the quantity and variety of assets or properties needed to operate. Treatment of different types of assets in accounting is in accordance with the guiding principles of valuation. It is mainly due to the importance of correct valuation of assets in accounting. Any error or manipulation in the valuation of assets means that the financial statements are not correct. The auditor, therefore, has to pay adequate attention to the problems associated with the valuation of assets.

### 6.3.1 Basis of Valuation

The alternative bases which may be used for valuation of assets are given in Table 28.1.



Table 28.1 : Basis of Valuation

Concept	Meaning	Identification
1) Cost Value	Price at which the asset was purchased	Old Purchase Price
2) Realisable Value	Price at which the asset may be sold	Market Price
3) Replacement Value	Price at which the asset may be purchased now	New Purchase Price
4) Scrap Value	Price which may be realised after the completion of the working life of the asset	Break-up Price
5) Book Value	Cost price less depreciation charged up till now	Written Down Value

Let us differentiate between the different values of an asset with the help of the following example.

Menaka Electronics Ltd. purchased a machinery for Rs. 10,000 in 1986. When the Balance Sheet of the company was being prepared in 1989, the selling price of the machinery in the market was Rs. 15,000 owing to a price-rise by the producers. In case the company decides to dispose off its old machinery, it is likely to fetch a price of Rs. 8,000. The normal working life of the machinery is estimated to last in 1990, and the scrap value is expected to recover Rs. 1,000.

The different values of the machinery in 1989 would be as follows :

- 1) Cost Value Rs. 10,000
- 2) Realisable Value Rs. 8,000
- 3) Replacement Value Rs. 15,000 plus Transportation, Installation etc.
- 4) Scrap Value Rs. 1,000
- 5) Book Value Rs. 2,800 after charging depreciation @ Rs. 1800 per annum for 4 years on Rs. 9,000 (i.e. cost less scrap)

### 6.3.2 Effect on Profits

It is necessary to emphasise that there is just one value of an asset which is the appropriate value at a point of time. The value may change with changes in the circumstances of the business. But so far as the present Balance sheet is concerned, it must show the position of the different assets in terms of their current accounting value. If an asset is valued on a basis different from the normally accepted principles of valuation, the accounts will not demonstrate a correct financial position. This is because of the inter-relationship between the value of an asset and the profit of the company. Valuation affects determination of profits. It also affects the correctness of the Balance Sheet. This happens in the following manner :

- i) Over-valuation of Assets  $\longleftrightarrow$  Charging less than required depreciation  $\longleftrightarrow$  Inflated Profits
- ii) Under-valuation of Assets  $\longleftrightarrow$  Charging more than required depreciation  $\longleftrightarrow$  Suppressed Profits

In both the situations, however, it will amount to manipulation of accounts when either (a) assets are over-valued, (b) assets are over-depreciated, (c) assets are under-valued, or (d) assets are under-depreciated. When the Profit and Loss Account shows a profit or loss which is different from the actual profit or loss of the business for the period under review, either by twisting valuation or depreciation to serve its own objectives, the financial statements will fail to disclose a true and fair view of the state of affairs. This will also be against the provisions of law. The auditor, therefore, always keeps in mind the profit implications of valuation of assets.

### Check Your Progress B

- 1) Fill in the blanks.
  - i) The price at which an asset is purchased is its .....
  - ii) The current market price of an asset is its ..... value.
  - iii) The value of an asset after its working life is .....
  - iv) The book value of an asset is its ..... minus .....
  - v) If less depreciation is charged on assets, this means ..... of assets.
  - vi) If an asset is depreciated more than its normal loss, the asset will be .....

- vii) If the value of assets shown in the Balance Sheet is more or less than its correct value, this will affect .....
- viii) The difference between the cost price and book value of an asset is .....
- ix) If an old machinery is repaired for its normal maintenance, the amount of expenditure should be treated as a ..... expenditure.
- x) The duty of an auditor is to verify the assets in respect of (a) ....., (b) ..... and (c) .....

- 2) What may be the alternative bases of valuation of assets?  
.....  
.....  
.....
- 3) What is the inter-relationship between valuation and profitability?  
.....  
.....  
.....

### 6.3.3 Modes of Valuation

You have seen that appropriate valuation of assets is an essential aspect of auditing. This means that the different types of assets are shown in the Balance Sheet at figures which are in conformity with :

- a) the principles of accounting
- b) the nature and characteristics of the business
- c) the method of valuation
- d) the pronouncements of the professional accountancy bodies.

In other words, proper valuation of assets expects that it is satisfactory from the point of view of accounting, business conditions, principles of valuation and auditing considerations.

Let us now identify the guiding principles of valuation in respect of: (1) Fixed Assets, (2) Current Assets, (3) Intangible Assets, and (4) Wasting Assets.

**Fixed Assets:** Fixed assets are of a relatively permanent nature. They are used to produce or to generate profit. They are expected to remain in the business till it ceases to be a going concern. Such assets are to help run the business, and are not for sale. The common examples of fixed assets are : Land, Building, Plant, Machinery, Furniture, etc.

The normal method of valuation of fixed assets is as follows:

- a) Fixed assets should generally be valued at cost, less a reasonable provision for depreciation (in respect of wear and tear, exposure, depletion, effluxion of time or obsolescence).
- b) Where a fixed asset is likely to need replacement at a materially higher price due to rising price levels, an additional amount should be set aside to provide further funds for eventual replacement.
- c) Depreciation on fixed assets should be so equitably distributed over the entire working life of the asset that the Profit and Loss Account of each accounting year effectively shares the proportionate loss for the period.

**Current Assets :** The business makes a continuous effort to convert some assets into cash in the normal course of trading. The purpose is to obtain profit on such conversions. Such assets are often of a short-term nature and they add to the liquidity of the organisation. For example, Stock, cash, book debts, investments etc. are treated as current assets.

In view of this characteristic of current assets, their mode of valuation is : Cost Price or Net Realisable Value, whichever is lower. In other words, if the company made some investments in corporate equity of Rs. 10,000, and its present market value comes down to Rs. 9,000, the value of investments to be shown in the Balance Sheet will be Rs. 9,000. In case, however, the value of investments appreciates in the market, that will not be taken into consideration for the purpose of valuation until the investments are actually sold and money is realised in cash. This means that while we take into account any loss or depreciation

sustained in respect of current assets, we do not show any profit or appreciation on such assets for the purpose of their present valuation.

**Intangible Assets:** Intangible assets are those assets which have no physical existence. But they are shown in the Balance Sheet as assets by virtue of their utility to the business, e.g., goodwill, patent, trade mark, copyright etc. Therefore, separate from the business, they may not have an independent value as such.

The question of valuation of intangible assets is governed by the following two considerations:

- a) Only properly chargeable amount should be debited to these heads; and
- b) Such items should be carried forward in the Balance Sheet at their actual figures until fully written off.

You may say that intangible assets should be at their lowest possible value, and that they should be written off at the earliest opportunity.

**Wasting Assets:** Such assets are of a fixed nature, but are gradually consumed or extracted. This process causes depletion or exhaustion in the value of the assets, e.g., mines, quarries, etc. Since the value of the asset continuously declines owing to its reducing stock, it is termed as a wasting asset.

The value of the wasting assets in the Balance Sheet is gradually reduced by the estimated amount by which it diminishes in value during the year. For example, if a coal mine is purchased for Rs. 20,000, and coal worth Rs. 5,000 is taken out of the mines during 1988-89, the value of the asset in the Balance Sheet for the year should be Rs. 15,000. Next year, if the estimated value of coal extracted from the mines is Rs. 7,000, then the value of the asset at the end of the year will come down to Rs. 8,000.

Let us now present our discussion in a nutshell. According to the accepted principles of valuation of different types of assets, the Balance Sheet should incorporate their figures on the following basis :

Table 28.2: Valuation of Assets

Category of Assets	Examples	Bases Adopted
1) FIXED ASSETS	Land, Building, Furniture, Machinery etc.	Cost Price less Depreciation to date
2) CURRENT ASSETS	Stock, Investments, Book Debt etc.	Cost Price or Realisable Value, whichever is less
3) INTANGIBLE ASSETS	Goodwill, Patent etc.	Minimum Actual Cost until completely written off
4) WASTING ASSETS	Mines, Quarry etc.	Estimated Diminished Value

Table 28.2 shows the major applications of the principles of valuation in respect of the different categories of assets. The underlying principle to be identified here is: While profits or appreciations in the value of assets may not be taken into account unless actually realised, all losses or depreciation in the value of assets must be written off as soon as they are known.

There is, however, one exception. A construction company or a contractor may value his work in progress at cost plus a proportion of profit earned thereon to the date of the Balance Sheet.

**Check Your Progress C**

- 1) What factors should be taken into consideration in valuation of assets?

.....  
 .....  
 .....

- 2) How are fixed assets valued?

.....  
 .....

- 3) How should an auditor treat current assets?

.....  
 .....

- 4) What is a wasting asset and how it is valued?

.....  
 .....

- 5) Mention against each item whether it is (a) Fixed Asset, (b) Current Asset, (c) Intangible Asset, or (d) Wasting Asset.

- i) Work in Progress .....
- ii) Goodwill .....
- iii) Loose Tools .....
- iv) Preliminary Expenses .....
- v) Garden .....
- vi) Sofa Set .....
- vii) Mica Mines .....
- viii) Refrigerator .....
- ix) Cash in Hand .....
- x) Stock in Trade .....

**6.3.4 Auditor's Position in Respect of Valuation of Assets**

The position of an auditor as regards the valuation of assets in a company is as follows:

- 1) It is the duty of the auditor not only to verify the physical existence and ownership of the asset, but also its valuation as shown in the Balance Sheet.
- 2) It is not sufficient for the auditor to check the arithmetical accuracy of the assets appearing in the Balance Sheet; he should also make enquiries through information and explanation to know the correct state of affairs.
- 3) It is not enough for the auditor to compare the items of the Balance Sheet with the books of account; he should also satisfy himself about the actual position of the assets.
- 4) An auditor is not a technical expert. He is not a valuer. He, therefore, need not value each and every asset himself.
- 5) An auditor may rely upon the directors of the company or on the certificates of other professionals in respect of the valuation of assets, provided he uses reasonable care and skill before showing that reliance.
- 6) In matters relating to valuation of assets, the auditor must adhere to the generally accepted principles of valuation, commercial practices and accounting standards.
- 7) The auditor should be careful to see that assets which do not exist are not included in the Balance Sheet; and those which exist do not contain any over-valuation or under-valuation.
- 8) The auditor should ensure that adequate depreciation has been charged on assets before determining their current value.
- 9) It is the responsibility of the management of the company to use a reasonable basis of valuation of assets, determine their correct value and to show them accordingly in the financial statements.
- 10) The auditor should state the basis of valuation of assets in the Balance Sheet as certified by directors or engineers, architects, surveyors, etc. as the case may be.

Thus the auditor examines the valuation of assets in order to ensure that the financial statements will give a true and fair view of the state of affairs of the company. He has greater responsibility to verify than to value. He should verify the original cost price and ascertain that the current values are fair and reasonable and are in accordance with the accepted commercial principles.

The auditor can safeguard his position of responsibility as well as liability in respect of valuation of assets by ensuring:

- 1) That the valuation of assets is based on proper **principles of accounting**; and

- 2) That the valuation of assets is in conformity with the **established practices** in the business and **accepted procedures** followed by the company in previous year.

In case of his dissatisfaction in any of these areas, however, the auditor should state the fact in his report.

## 6.4 VERIFICATION AND VALUATION OF SPECIFIC ASSETS

Let us now apply the principles to specific assets with regard to their verification and valuation. We have seen earlier in our discussion that verification and valuation of assets are almost interrelated techniques. This means that it is a combined consideration to examine the position of different assets appearing in the Balance Sheet.

A business need various assets to manage its affairs. Their size and variety, however, change according to the needs of the business. It is, therefore, not necessary to find all categories of assets in every company. The major considerations in respect of verification and valuation of some of the common examples of assets can be identified through following discussion.

### 6.4.1 Goodwill

Goodwill is an intangible asset. It represents the earning capacity of the business. A company running in loss may not be justified in having goodwill. This means that the value of goodwill fluctuates with increase or decrease in the profits of the company. Goodwill is synonymous with the reputation of the business and with its ability to command a fair share in the market.

In respect of verification and valuation of goodwill, the main considerations are:

- 1) to check the price paid for goodwill if it has been acquired from any other firm;
- 2) to examine the purchase consideration including goodwill by taking into account the excess of the book value of assets taken over by the company; in this case,  

$$\text{Goodwill} = \text{Purchase Price} - \text{Net Assets}$$

$$\text{or} = \text{Purchase Price} - (\text{Assets} - \text{Liabilities})$$
- 3) to ascertain that the company is justified in creating goodwill in its books of account;
- 4) to satisfy about the relevance and method of creation of goodwill appreciating the fact that it is an estimated value and not an exact expenditure;
- 5) to ensure that goodwill is being written off out of current or capital profits of the company at the earliest opportunity; and
- 6) to see that goodwill is not shown in the Balance Sheet at its realisable value; it should be at cost less the amount written off.

### 6.4.2 Freehold Property

A freehold property includes such land and buildings which are absolutely owned by the company. Its verification and valuation should be on the following lines:

- 1) to examine the title deeds in respect of their genuineness and completeness of the property;
- 2) to check that the property is fully owned by the company and is in its free and fair possession;
- 3) to ensure that proper depreciation has been provided for the property;
- 4) to ascertain that the property has been duly insured to cover it against undue risks and that premium thereon has been paid on time;
- 5) to compare the item with that of brokers or auctioneers' account if it is a purchased property, and to refer to contractors' or architects' certificate if it is a constructed property;
- 6) to see that the property has been valued for Balance Sheet at cost (including legal and registration charges) less depreciation till date; and
- 7) to satisfy that depreciation is charged on freehold building only, but not on freehold land.

### 6.4.3 Leasehold Property

Sometimes assets are acquired by the company on lease for a particular period. This means that such properties are governed by the terms and conditions attached with the lease

agreement. For the purpose of verification and valuation of leasehold property the auditor should make the following approach:

- 1) to check that the company maintains separate accounts for freehold and leasehold properties;
- 2) to examine the lease deed and ascertain that all conditions in respect of payment etc. have been duly complied with;
- 3) to find out the value and duration of the lease and to ensure that it is still in existence on the date of the Balance Sheet;
- 4) to see that proper provision for depreciation on leasehold property has been made;
- 5) to inspect that the lease agreement has been duly registered;
- 6) to make sure that the money paid for the acquisition of the lease and for its registration has been treated as capital expenditure;
- 7) to ascertain whether lease rent, insurance, repairs etc. have been debited to revenue account;
- 8) to take note of the last payment made for lease in order to maintain its due continuity; and
- 9) to be sure that the item of leasehold property is being placed in the Balance Sheet with the required details.

### 6.4.4 Plant and Machinery

A manufacturing company often needs a set of plant and machinery to assist the process of production. Verification and valuation of this item of Balance Sheet needs the following considerations:

- 1) to compare the ledger accounts for the balances drawn in respect of plant and machinery;
- 2) to refer to the original invoices, correspondence or other vouchers in support of their acquisition;
- 3) to check the Plant Register which should incorporate the date, cost, sales, depreciation and other developments regarding the various plants in the company;
- 4) to get a schedule of plant and machinery in existence at different units;
- 5) to conduct spot inspections for the physical existence of some plant and machinery;
- 6) to ensure that the plant and machinery have been valued at cost less depreciation as a going concern;
- 7) to see that additions, alternations, substitutions etc. have received appropriate adjustments during the year;
- 8) to ascertain whether expenses relating to repairs and renewals have been debited to revenue account;
- 9) to exclude such plants and machineries which are not owned by the company and have been in use on rental or hire basis;
- 10) to determine the appropriate profit or loss on machineries which have been sold, destroyed or scrapped during the year; and
- 11) to examine that the loss in respect of depreciation on plant and machinery has been estimated properly and adequate rate of depreciation is charged on this asset.

### 6.4.5 Furniture and Fixtures

The administration needs chairs, tables, racks, almirahs etc. which are items of furniture. Fixtures are fittings like fans, air-conditioners, coolers, geysers etc. So furnitures are normally moveable property while fixtures are immovable. Their verification and valuation should be in the following manner:

- 1) to check that a Stock Register is maintained incorporating the details of the various items purchased, their cost, department to which it is allotted, depreciation, balance amount of value etc.
- 2) to ensure that the amount and the rate of depreciation charged on different items is based on a fair estimate of their working life;
- 3) to examine the payments made in respect of the purchase of furniture and fixtures through the invoices of the suppliers;
- 4) to take note of the additions during the year and their treatment as capital expenditure;
- 5) to compare the final balance of the item as shown in the Balance Sheet with their current value;

- 6) to see that all repairs are treated as revenue expenditure;
- 7) to find out if the Stock Register has given serial numbers to every item and they have been identified accordingly for the purpose of enforcing an effective system of stock control;
- 8) to get such items written off under proper authority which are lost, damaged, not in use or out of order; and
- 9) to take note of the final position of the item being presented in the Balance Sheet in terms of its written down value.

#### 6.4.6 Motor Vehicles

Assets like cars, trucks, pick-up vans, jeeps etc. are covered under the head of motor vehicles. The auditor should verify and value such assets by following the undermentioned procedures :

- 1) to check the Motor Vehicles Register if the company has a number of vehicles;
- 2) to see that separate details have been maintained in the register for every vehicle in respect of its date of purchase, cost, registration number, engine number, chassis number, etc.;
- 3) to ensure that all additions or acquisitions during the year have been properly capitalised;
- 4) to ascertain that all vehicles have been duly insured against accidents, theft, damage and other risks, and that premiums have been paid on time;
- 5) to examine the adequacy of depreciation charged on vehicles so that they are shown in the Balance Sheet at cost less depreciation;
- 6) to scrutinise the invoices relating to the supply of vehicles to the company;
- 7) to refer to the Registration Books for confirming the name of the owners;
- 8) to find out if proper distinction has been made in the books of accounts as regards capital and revenue expenditure — purchases to be capitalised and normal repairs or maintenance charges to be treated as revenue; and
- 9) to confirm that the final balance shown in the Balance Sheet against this item takes into account all adjustments up to date.

#### 6.4.7 Patents

Patent rights are obtained through certificates granted for the purpose. Such rights are acquired either through purchase or experiments by research and development. The role of the auditor in verification and valuation of patents is as follows :

- 1) to see that the patents have been registered in the name of the company;
- 2) to ensure that fees paid for the purchase of patents or expenses incurred on research are treated as capital expenditure and debited to Patents Account;
- 3) to check that renewal fees paid for patents is treated as revenue expenditure;
- 4) to examine the life of the patents, which usually expires after 16 years, and to confirm that it has not lapsed owing to its non-renewal;
- 5) to refer to the supporting deeds and documents relating to patents;
- 6) to inspect the payment vouchers and receipts relating to patents fees;
- 7) to obtain copies of resolutions granting the lapse of some patents after its normal term of 16 years;
- 8) to estimate the value of patents after charging adequate depreciation; the cost of patents is to be completely written off by the time its commercial value is over; and
- 9) to make sure that patents are clearly stated in the Balance Sheet under separate head with appropriate value.

#### 6.4.8 Trade Marks and Copyrights

Trade marks and copyrights allow exclusive authority to the company to trade in specified areas. Trade marks are registered in favour of the company and copyright give power to produce or reproduce a written work. Verification and valuation of such rights are done by the auditor by examining that :

- 1) the rights in respect of trade mark and book production remain valid as on the date of the Balance Sheet;
- 2) the depreciated value of such right is estimated after taking into account the remaining duration of the assets;

- 3) the items are immediately written off if they do not command any value now;
- 4) the supporting deeds and other documents confirm the ownership and continuity of the rights;
- 5) payments made in respect of trade marks and copyrights have adequate supporting vouchers and they have been properly treated in accounts;
- 6) appropriate revaluation is used as the basis of charging depreciation on copyrights and this is substantiated by certificates of experts;
- 7) renewal fees is paid annual at the right time; and
- 8) the company has separate schedules of trade marks and copyrights confirming their final value as shown in the Balance Sheet.

#### 6.4.9 Assets Acquired and Hire Purchase

Sometimes assets are obtained on the basis of hire purchase agreements. In this case, the auditor verifies and values such items by the following methods :

- 1) examination of the terms and conditions contained in the hire purchase agreements;
- 2) checking of instalment payments and their treatment as capital expenditure debited to the asset account;
- 3) interest on unpaid balances are charged to revenue account;
- 4) proper depreciation is provided on the full cash purchase price of the assets;
- 5) the value of the asset shown in the Balance Sheet takes note of the total outstanding instalment; and
- 6) the asset is shown in the Balance Sheet after deducting depreciation.

With this, we conclude our present discussion. There are, however, some more assets and liabilities which need verification and valuation. We shall now, therefore, pass on to a study of some additional areas of verification and valuation of assets and liabilities in the unit which follows.

### 6.5 LET US SUM UP

Verification is a process of checking the existence, ownership and valuation of different assets appearing in the Balance Sheet.

The basis of valuation of assets may be: (a) Cost Price, (b) Realisable Value, (c) Replacement Value, (d) Scrap Value, and (e) Book Value. They are also influenced by: (a) Purchase Price, (b) Market Price, (c) Break-up Value, and (d) Written-down Value:

As valuation, depreciation and profitability are closely interrelated treatments, they very much affect the state of affairs shown by the financial statements.

Assets may be classified into four categories: (i) Fixed Assets, (ii) Current Assets, (iii) Intangible Assets, and (iv) Wasting Assets. Normally their valuation depends on their cost or depreciated value, whichever is lower.

Although an auditor is not a valuer, he must exercise reasonable care and skill to ensure that the assets have been valued properly in accordance with the principles of accounting as well as the accepted professional practices. This may be done either by the company or by valuation experts.

Verification and valuation of assets like Goodwill, Freehold Property, Leasehold Property, Plant and Machinery, Furniture and Fixtures, Motor Vehicles, Patents, Trade Marks and Copyrights and Assets acquired on Hire Purchase need some special considerations in accordance with the characteristic features of every item.

### 6.6 KEY WORDS

**Acquisition:** Purchase, ownership and possession of an asset.

**Book Value:** The value at which an asset stands in books of account.

**Charges:** An asset being used as a security for obtaining loans and advances.

**Cost:** The actual original price or payment made towards the acquisition of an asset.

**Current Assets:** Assets which are likely to be converted into cash in the short run.

**Depreciation:** Loss or diminution in the value of an asset owing to wear and tear, effluxion of time, obsolescence or any other similar reason.

**Disclosure:** Presentation of an item of asset or liability in the Balance Sheet at the prescribed value in the defined order.

**Evidence:** A voucher or any other relevant, reliable and acceptable document in support of a transaction.

**Existence:** When the asset is actually located at a particular point or place.

**Fixed Asset:** Assets which are normally not moveable.

**Installation:** The setting up of a plant or machinery to put it into production.

**Intangible Assets:** Assets which do not physically exist but are still part of the business.

**Maintenance:** Keeping an asset in order for its normal operation, production, use or functioning.

**Obsolescence:** The possibilities of getting an asset out of date due to some better scientific invention as a substitute to the old equipment.

**Ownership:** An asset which legally belongs to the company.

**Over-valuation:** Showing an asset at a value higher than its normal value.

**Possession:** Assets which are under use and authority of the company.

**Realisable Value:** The price which an asset may fetch in the market.

**Replacement:** An old asset being substituted by a similar other new asset.

**Scrap:** The ultimate or last value of an asset after the completion of its working life.

**Title:** The legal ownership of an asset.

**Under-valuation:** Showing an asset at a value lower than its normal value.

**Valuation:** The monetary or financial worth of an asset on the basis of some defined principle.

**Wasting Asset:** Assets which continuously decline in their value due to extraction or depletion.

**Written-down Value:** The cost price of an asset less depreciation charged on it up to now.

## 6.7 ANSWERS TO CHECK YOUR PROGRESS

- A 5 (i) False (ii) False (iii) True (iv) False (v) True (vi) True  
 B 1 (i) Cost (ii) Realisable (iii) Scrap (iv) Cost, Depreciation (v) Over-valuation  
 (vi) Under-valued (vii) Profit (viii) Depreciation (ix) Revenue  
 (x) (a) Existence (b) Value (c) Title  
 C 5 (i) Current Asset (ii) Intangible Asset (iii) Current Asset (iv) Intangible Asset  
 (v) Fixed Asset (vi) Fixed Asset (vii) Wasting Asset (viii) Fixed Asset  
 (ix) Current Asset (x) Current Asset

## 6.8 TERMINAL QUESTIONS

- 1) Point out the difference between 'Verification' and 'Valuation' of assets.
- 2) Discuss the objects of verification of assets.
- 3) 'An auditor is not a valuer, but he is intimately connected with values'. Explain.
- 4) How would you verify the following:
  - (a) Goodwill
  - (b) Freehold Property

- 5) State the considerations which govern the valuation of different types of assets.
- 6) Examine the position of an auditor as regards valuation of assets.

**Note:** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the University. These are for your practice only.

## UNIT 7 VERIFICATION & VALUATION OF ASSETS AND LIABILITIES II

### Structure

- 7.0 Objectives
- 7.1 Introduction
- 7.2 Verification and Valuation of Investments
- 7.3 Verification and Valuation of Current Assets
  - 7.3.1 Cash in Hand
  - 7.3.2 Cash at Bank
  - 7.3.3 Book Debts
  - 7.3.4 Bills Receivable
  - 7.3.5 Loans and Advances
- 7.4 Verification and Valuation of Stock-in-Trade
  - 7.4.1 Method of Stock Taking
  - 7.4.2 Basis of Valuation
  - 7.4.3 Auditor's Duty
- 7.5 Verification of Specific Liabilities
  - 7.5.1 Trade Creditors
  - 7.5.2 Bills Payable
  - 7.5.3 Outstanding Expenses
  - 7.5.4 Incomes Received in Advance
  - 7.5.5 Loans
  - 7.5.6 Contingent Liabilities
- 7.6 Let Us Sum Up
- 7.7 Key Words
- 7.8 Answers To Check Your Progress
- 7.9 Terminal Questions

### 7.0 OBJECTIVES

After studying this unit you should be able to

- explain the process of verification and valuation of investments
- apply the principal considerations to certain current assets like cash, book debts, stock, etc.
- explain the method of verification of some major liabilities.

### 7.1 INTRODUCTION

In Unit 28 you have learnt how important verification and valuation are in the process of auditing. Our present discussion is in continuity of our study in the last unit. While we had devoted our attention in Unit 28 to the principles of verification and valuation and their application to some important assets in a company, we shall now discuss in this unit the practical considerations required for the verification and valuation of some other assets as well as some liabilities.

### 7.2 VERIFICATION AND VALUATION OF INVESTMENTS

A company may utilise its surplus resources in investments. Normally such investments are made in securities like shares, bonds and debentures. The major task of an auditor is to verify the existence of such investments and to ensure that they are shown in the Balance Sheet at a correct value.

The process of verification and valuation of investments should include the following considerations by the auditor:

- 1) That the company maintains a **schedule** of investments for the auditor showing the

- names of the investments, dates of acquisition of securities, their face value, cost price, book value, paid-up value, market value, rates of interest, dates of interest due, tax deductions etc. at the date of the Balance Sheet.
- 2) That a comparison of the schedule of investments with the **ledger** accounts does not show any discrepancy.
- 3) That an examination of the purchase of investments shows that the deal has been duly **authorised** by the Board of Directors.
- 4) That the prices recorded to have been paid by the company for the purchase of securities are fully supported by their letters of **allotment**.
- 5) That in case securities have been purchased in the secondary market, stock exchange quotations, payees' receipt, and brokers' voucher confirm the **price** paid for investment.
- 6) That all investments made by the company and included in the Balance Sheet are actually in the **name** of the company.
- 7) That funds used in investments are in conformity with the **provisions** of the memorandum and articles of association of the company in respect of such assets.
- 8) That all purchases and sale of securities are fully supported by adequate **approval** of the authorities.
- 9) That a personal **inspection** of all the securities simultaneously satisfies the auditor in respect of their existence.
- 10) That a **Register** of Investments is maintained by the company incorporating relevant details about the securities acquired and prices paid and these details tally with the schedule of investments as well as with the securities.
- 11) That if some of the securities of the company are in **safe custody** of a bank, banker's certificate is obtained as a supporting evidence showing the names in which securities are registered.
- 12) That an examination of different securities and other documents shows that all securities are free from any **charge** or encumbrance.
- 13) That if some of the securities have been transferred to or by the company, their transfer **deeds** are in order.
- 14) That proper **vouching** is done for entries in the Cash Book or Bank Pass Book in respect of securities sold during the year.
- 15) That proper **provisions** have been made for interest or dividend accrued during the year.
- 16) That all investments have been **valued** properly on the basis of their cost price or market price whichever is less, i.e. adequate adjustment is made for any decline in the book value of securities in comparison with their market value.
- 17) That a separate register is maintained for investments which are not held in the **name** of the company showing the purpose of such investments.
- 18) That interest and dividend received on investments have been duly **credited** in respective ledger accounts and provisions have been made for interest accrued but not received or dividend declared but not collected.
- 19) That amount due on partly-paid shares has been shown as **contingent liabilities**.
- 20) That the total amount of investments shown in the Balance Sheet consisting of different types of securities are properly **disclosed** in the financial statements.

These considerations help the auditor in verification and valuation of investments. Let us now study the process as applicable to some current assets.

#### Check Your Progress A

- 1) Name three forms of securities suitable for investment:
  - i) .....
  - ii) .....
  - iii) .....
- 2) State three forms of return on investment:
  - i) .....
  - ii) .....
  - iii) .....
- 3) Give three methods of valuation of an investment:
  - i) .....
  - ii) .....
  - iii) .....
- 4) Identify three sources of making investment:
  - i) .....
  - ii) .....

- iii) .....
- 5) Examine the audit implications of the following:
- Interest accrued but not received
  - Dividend declared but not collected
  - Interest received but not credited
  - Securities sold in market at a higher price
- 6) Show the meaning of the following:
- Allotment
  - Brokerage
  - Premium
  - Discount
  - Partly-paid Share

### 7.3 VERIFICATION AND VALUATION OF CURRENT ASSETS

Some of the current assets which we intend to examine from the point of view of their verification and valuation are : Cash in Hand, Cash at Bank, Book Debts, Bills Receivable and Loans and Advances.

#### 7.3.1 Cash in Hand

Misappropriation or embezzlement of cash has been a common technique of fraud. The auditor, therefore, has to be very careful in verification of cash in hand. The major approach of the auditor regarding verification and valuation of cash in hand should be to:

- Make surprise visits to the offices where cash is kept.
- Count the cash balance and compare it with the balance shown in the cash book, particularly at the closing or opening time.
- Take note of the **shortage** or surplus of cash in the presence of the cashier.
- Obtain a **certificate** of shortage of cash from the cashier in case of such discrepancy.
- Ascertain the balances in respect of (a) cash at branches, (b) cash with agents, (c) cash in transit, (d) stamps in hand, (e) petty cash, and (f) cash in hand, and ensure that they are not **mixed up** at the time of their verification.
- Check simultaneously the different types of cash balances maintained by the company so that shortages of one are not met by **transfer** from another balance.
- Ask the company preferably to **deposit** all cash balances available on the date of the Balance Sheet in bank accounts when he finds it difficult to count them at the close of the year.
- Examine the receipts and payments shown in the **cash book** and verify its balance on the day he conducts a cash count
- Inspect if the cash in hand includes cheques, drafts or some temporary advances to staff, they should be separated under authority and properly **recorded** in books of account.
- Discourage the practice of keeping substantial amount of funds as cash in hand from the point of view of **internal control**.
- Get certificates from the branch auditors where he finds it difficult to verify cash in hand at the **branches** of the company.
- See that cash with agents or in transit are duly supported by documentary **evidence** to that effect.

#### 7.3.2 Cash at Bank

For the purpose of verification and valuation of cash at bank, the auditor should :

- Reconcile the balance shown by Pass Book with the Bank Account balance of the Cash Book.
- Obtain a Certificate of Balance in company's account as on the date of the Balance Sheet from the bankers.
- State the nature and balance of bank deposits under respective heads such as Fixed Deposit, Current Account Balance, Savings Bank Account balance, etc.
- Ensure that the pending items on the date of the Balance Sheet are subsequently adjusted, e.g. cheques issued but not presented for payment, cheques deposited but not credited, etc.

- Confirm that cheques issued for more than six months are treated as unpaid cheques and the relative entries are reversed.
- See that cash at bank is reconciled even up to the date on which audit is being done.
- Examine the Fixed Deposit Receipts in respect of their dates of issue, amount, rates of interest, name of the company, etc. and get the interest accrued on deposits during the year duly adjusted.
- Conduct further enquiries about the security lodged and interest charged by the bank if the bank account of the company shows a debit balance owing to some overdraft.

#### 7.3.3 Book Debts

Books Debts comprise such outstanding balances against customers and other business claims which have to be recovered from them at the earliest.

The auditor should adopt the following procedures for the verification of Book Debts in a company:

- Circularisation of debtors:** The auditor should arrange to obtain a direct confirmation of balances from the debtors by sending letters. This may be done on a selective basis including such categories of debts which are: (a) substantial in amount, (b) year-end debts, (c) relating to the principal customers of the company, and (d) showing nil balances. If any discrepancy is discovered from the replies of the debtors, or if some of the letters are received back undelivered, the auditor should conduct further enquiries in the matter. The auditor must also be careful to examine :
  - amount paid by debtors, but not credited in their accounts;
  - goods sold on credit, but customer's account not debited;
  - disputed balances owing to some claims or complaints; and
  - credit notes issued to parties.
- Checking year-end receipts:** The auditor should ensure that all payments received from debtors, particularly towards the closing of the year, are properly credited to their accounts. Such receipts must also be supported by duly authorised vouchers issued by the company acknowledging payments in respect of debts.
- Ascertaining bad and doubtful debts:** The auditor should first obtain a schedule of bad and doubtful debts from the company which should be duly certified by a responsible official. He should then examine the possibilities of realising such debts and check the amount estimated under these heads. The auditor should also take into account the following factors :
  - the normal period for which credit is normally granted by the company and the age of the debts under consideration;
  - cheques issued by the debtors but dishonoured on presentation;
  - current financial position of the party and his capacity to repay the debt;
  - unusual delay in recovery of debts;
  - failure to honour commitments of instalments to redeem the debt; and
  - nature of securities, if any, offered for the debt.

The auditor should also consider : (i) the terms of credit allowed by the company, (ii) cash discounts offered for timely repayments, (iii) erratic payments made by parties, (iv) increasing balances of individual debts, (v) parties going into liquidation, (vi) parties who are untraceable etc. These factors govern the total amount of book debts as well as their classification into good, doubtful and bad debts.

It is only when the auditor is fully satisfied about the irrecoverable nature of a debt, despite all efforts of the company, that he should allow a debt to be written off as a bad debt. In case some of the debts appear to be doubtful in respect of their recovery or realisation, a suitable provision should be made for such debts in the accounts.

#### 7.3.4 Bills Receivable

Bills of Exchange which remain unpaid on the date of the Balance Sheet are included under the head 'Bills Receivable'. This is an asset which is normally converted into cash if the bill is met on its due date. Some of the bills, however, may be discounted through the bankers before their maturity. In that case, the amount received may be slightly less than the face

value of the bill. If a discounted bill is dishonoured, it becomes a liability for the company to repay what it has received from the bankers.

In view of this nature of the item, the auditor has to consider the different aspects of the transaction to establish the identity of Bills Receivable. **The process of its verification and valuation by the auditor should incorporate the following :**

- 1) Get from the company a schedule of unpaid bills in hand on the date of the Balance Sheet.
- 2) Inspect the bills in hand and compare them with their total in Bills Receivable Account.
- 3) Check the proceeds received from bills discounted.
- 4) See that the bills are properly drawn, stamped, duly accepted and not overdue for payment.
- 5) Make provision for possible losses on bills likely to be dishonoured.
- 6) Ascertain that bills matured but not paid have been duly renewed.
- 7) Obtain certificate from bankers in respect of bills kept with them in safe custody, deposited for collection, or used as security for loans.
- 8) Confirm that bills discounted before the close of the year but likely to be dishonoured are shown as contingent liabilities at the bottom of the Balance Sheet.
- 9) Ensure that bills dishonoured have been properly noted and protested, they are excluded from Bills Receivable in hand and the acceptors of the bills are treated as debtors.
- 10) Examine that discount charged on bills maturing after the date of the Balance Sheet are treated separately and shown as 'Rebate on Bills Discounted not yet due'.
- 11) Exclude such bills from the Balance Sheet which might have been retired before their maturity or before the date of the Balance Sheet and check that their proceeds have been properly credited in the Cash Book.

### 7.3.5 Loans and Advances

Loans and advances may be given by the company to different parties either as fully secured, partly secured or totally unsecured. Such loans are temporary advances likely to be recovered soon. They are, therefore, supported by their own terms and conditions which govern the quantum, interest, repayment and security of loans.

Verification and valuation of loans and advances by the auditor should be based on the following considerations :

- 1) Obtain a list of all advances and compare them with the respective balances in the ledger.
- 2) Ascertain that the advances are properly authorised and are being recovered regularly in agreed instalments.
- 3) Ensure that adequate provisions have been made in respect of irrecoverable advances.
- 4) Inspect loan agreements or correspondences relating to the terms of the loan.
- 5) Refer to the Memorandum and Articles of Association of the company for the policy and procedure on loans and advances.
- 6) Confirm that loans are sanctioned by persons who are having the financial powers and administrative competence to do so.
- 7) See that loans are duly acknowledged by the debtors and promotes are executed or bills of exchange are drawn for the purpose.
- 8) Examine the terms and conditions on which loans are granted and satisfy that they are not against the interest of the company or its members.
- 9) Check the securities or documents offered for loans, e.g. promissory notes, land mortgage deeds, insurance policies, etc.
- 10) Enquire the rate and date of interest payable and see their adjustment in accounts.
- 11) Consider the possibilities of some of the loans outstanding for a long time and the chances of their being bad or doubtful debts.
- 12) Get the outstanding balances of loans confirmed by the borrowers.

These are some of the current assets which need audit verification and valuation. Let us now discuss the process of verification and valuation of another important asset appearing in the Balance Sheet, i.e. Stock-in-Trade.

#### Check Your Progress B

- 1) How can you check the authority of advances made by a company?

- 2) How can you verify the cash balance of an office which you cannot visit?
- 3) What is the method of verification of a debt which is fully secured?
- 4) How are such Bills Receivable treated in accounts which are not honoured on maturity?
- 5) Fill in the blanks :
  - i) The best method of verification of Cash in Hand is .....
  - ii) It is ..... to keep substantial amount of funds as Cash in Hand.
  - iii) Difference between Pass Book and Cash Book balances needs .....
  - iv) A debt which cannot be realised should be treated as .....
  - v) Bills Receivable discounted before maturity, but likely to be dishonoured on presentation are considered as .....

## 7.4 VERIFICATION AND VALUATION OF STOCK-IN-TRADE

Stock-in-Trade is a floating asset. It is a part of inventory. It is either : (a) to be converted into cash by sale, or (b) to be used in the process of production, or (c) is meant for consumption in producing goods or services. It is, however, subject to both manipulation and misappropriation. There are enough possibilities of theft, pilferage, wastage, issue without proper authority, non-entry of goods received or destruction by fire of stock. In all such cases, a loss is caused to the organisation. This needs an effective system of internal control so that both goods inwards and goods outwards remain under constant watch. Besides safety and security of stock, notional fluctuations in its value need supervision. The auditor, therefore, must ensure that the stock-in-trade as shown in the Balance Sheet is actually in existence and that their value too is in accordance with the generally accepted principles of accounting.

We shall now discuss the problem of verification and valuation of stock-in-trade under three main heads : (i) Method of Stock Taking, (ii) Basis of Valuation, and (iii) Auditor's Duty.

### 7.4.1 Method of Stock Taking

It is necessary to verify the stock in hand from time to time. For the purpose of determining the quantity as well as value of stock-in-trade as on the date of the Balance Sheet, the following method is adopted :

Opening Stock (at the beginning of the year)	.....
Add Purchases during the year	.....
Less Sales during the year	.....
Closing Balance, i.e. Stock-in-Hand at the end of the year	.....

A normal margin may be allowed for wastage, shrinkage or evaporation of stock in making in calculation. In case of raw materials, etc., purchases and sales may be substituted by the estimates of materials received and issued in stock.



Once the quantity of goods in hand on a particular date has been ascertained from records, it may be verified through the process of physical count. Then the company will be in a position to know whether there is any shortage or surplus of stock and the possible reasons for such discrepancy.

Verification of stock by physical count is the duty of the management. The auditor, however, should make himself present at the time of physical count (stock taking). He should observe whether the method of stock taking is satisfactory and should apply test checks on the verification date by management.

Principal considerations regarding stock taking are as follows:

- 1) Stock should be checked normally at the time of closing the year.
- 2) Each item in the store and its quantity should be recorded in the Stock Sheet.
- 3) The recorded quantity should be cross-checked by another set of staff.
- 4) A responsible official should mention the rate against each item which is applicable for its valuation.
- 5) The total value of each item (quantity multiplied by rate) should be determined and stated in the Stock Sheet.
- 6) All calculations should be checked once again by another staff and signed by him.
- 7) The Stock Sheet should be finally submitted to the appropriate authorities of the company for their approval and signature.
- 8) The entire process of stock taking should be conducted under the supervision of a responsible official.

#### 7.4.2 Basis of Valuation

Valuation of Stock-in-Trade is an importance process of accounting and auditing. Normally stock is valued at cost or net realisable value whichever is lower at the date of the Balance sheet. It is compared to the market price or replacement price also. But the common principle is to write off expected losses. Anticipated profits, however, are not taken into account. Correct valuation of stock affects the correct determination of profit or loss of the company for the current year as well as the next year.

You know there are various method of valuation of stock. But, the normal practice of valuation of stock is to take either of the three methods of costing:

- a) FIFO
- b) LIFO
- c) Average Cost

Whatever basis of valuation of stock is used, it must be reasonable and must followed consistently from year to year. Then, it is important that we take into account a fall in the price of goods, even if it is owing to obsolescence or damage, but should not value the stock at a price higher than the cost price.

#### 7.4.3 Auditor's Duty

It is an important part of the duty of an auditor to verify and value the stock-in-trade. It is, however, extremely difficult for an auditor to verify each and every item of stock. Proper valuation of the stock too may be difficult for them because of his limited technical knowledge. He may, therefore, rely upon the stock records maintained by the company and apply tests which are practicable in the circumstances.

Moreover a certificate should be obtained from the responsible official of the company in respect of a detailed procedure followed for stock taking and the method of valuation used. The certificate should clearly state the following:

- i) to the best of my knowledge and belief the quantities and values shown in the stock sheets are correct;
- ii) items included in the stocks are the property of the company only;
- iii) no such item has been included in the stock for which purchase has not been recorded in the books of account;
- iv) no such item has been included in the stock which has been sold but for which delivery has not taken place;
- v) depreciation has been provided for all such goods that are unsuitable for sale or have been damaged or are obsolete;
- vi) the basis of valuation of stock is the same as followed in the previous years; and
- vii) plants, used tools, furniture or any other fixed assets has not been included in the stock.

It is not the duty of the auditor to take stock. He may believe the officers of the company for the stock-in-hand. But he will be considered to have failed in his duty if he does not exercise reasonable care and skill in verifying the reports and statements relating to stock. An auditor is also not a valuer. But he will be held responsible for not detecting over-valuation of stock. He, therefore, must satisfy himself about the physical as well as financial accuracy of the stock-in-trade.

Verification and valuation of Stock-in-Trade should receive the following audit considerations:

- 1) Check the stock sheets in respect of the quantities of different items shown, the prices charged against each and signing authority who has supervised the total valuation.
- 2) Examine the method of costing applied for valuation and compare it with the information available in costing records or invoices.
- 3) Text a few specific items appearing in the stock statement, both in terms of their quantities and prices.
- 4) Look at the additions and their carry forwards on the next page.
- 5) Ensure that no item of stock is over-charged by loading undue additional expenses like transport duty, insurance, carriage, etc.
- 6) Exclude items which do not form part of the closing stock of the company, e.g., goods sent on consignment, goods at warehouse, ports or with customs.
- 7) Evaluate the method of stock maintenance and stock taking followed by the company from the point of view of safety and internal control ensuring that the process is free from any risk; also obtain a copy of the instructions issued to staff for stock taking.
- 8) Confirm that proper depreciation has been provided for defective, destroyed or obsolete stock.
- 9) See the corresponding entries in the Goods Inward and Goods Outward Registers particularly those relating to year-end transactions.
- 10) find out if the stock sheet includes such items which are normally not part of the stock-in-trade, e.g. loose tools, plant, furniture, etc.
- 11) Reconcile whether the quantity and cost of items shown by the stock sheet, stock book, trading account and balance sheet tally.
- 12) Conduct vouching of some sales and purchases affecting the balance of stock-in-hand.
- 13) Compare the current rate of Gross Profit on Sales with that of previous year and identify if there is any major difference without reasonable justification.
- 14) Make provision for losses on account of unsaleable or unsuitable goods by writing them off in books of account

Now a days, standard accounting practices all over the world require that auditors should carry out necessary audit procedures to satisfy himself about this accuracy of the amount at which inventories are included in the financial statements.

#### Check Your Progress C

- 1) Why should the auditor obtain a certificate from a responsible official of the company in respect of Stock-in Trade ?  
.....  
.....
- 2) State whether the following statements are True or False.
  - i) Over-valuation of stock improves the dividend paid by a company.
  - ii) All stock taking as must be supervised by the author.
  - iii) The value of Stock-in Trade depends on its current market price.
  - iv) Goods in transit form of Stock-in-Trade.

### 7.5 VERIFICATION OF SPECIFIC LIABILITIES

Like verification of assets, verification of liabilities is an equally important process of auditing. It affects the correctness of the financial statements in the same way as the assets. In case of liabilities, however, the major problems of verification are:

- a) Over-statement of liabilities,
- b) Under-statement of liabilities, or
- c) Omission of liabilities.

In all such situations, neither the Profit and Loss Account nor the Balance Sheet will give a correct picture of trading operations. Besides a normal verification of liabilities, the auditor should also obtain a certificate from the company:

- i) that all liabilities for purchases, expenses or any other item existing at the date of the Balance Sheet have been included in the books of account; and
- ii) that all the contingent liabilities of the company for the period have been disclosed in a footnote to the Balance Sheet or have been provided for.

Let us now discuss the process of verification of some major liabilities like: (a) Trade Creditors, (b) Bills Payable, (c) Outstanding Expenses, (d) Incomes Received in Advance, (e) Loans, and (f) Contingent Liabilities.

### 7.5.1 Trade Creditors

The method of verification of trade creditors should include the following :

- 1) Get a schedule of creditors from the company and examine it with Purchases Ledger, Bills Payable, Cash Book, Credit Notes, Goods Inward Book, Returns Outward Book, Invoices, etc.
- 2) Ensure that all purchases made during the year, particularly the year-end purchases, are recorded in the books of account.
- 3) Obtain confirmation from the creditors in respect of their outstanding dues to the company and compare them with the schedule of creditors.
- 4) Analyse the percentage of gross profit earned this year, compare it with that of the previous year and identify if there is any remarkable change without adequate justification.
- 5) Test such items of creditors which have not been paid for a long time and find out the reasons.
- 6) Check the possibilities of a payment already shown to creditors, but not actually paid and amount misappropriated.

### 7.5.2 Bills Payable

Audit verification of Bills Payable needs the following considerations :

- 1) Obtain a schedule of Bills Payable in hand as on the date of the Balance Sheet from some responsible official of the company.
- 2) Check the Bills Payable Book, Bills Payable Account and Cash Book in respect of bills already paid and still payable.
- 3) Get confirmation from the drawers or holders of the bills as regards amount due on the bills accepted by the company.
- 4) Examine if a bill has been accepted by creating a charge on any asset of the company and this has been properly disclosed in the Balance Sheet.

### 7.5.3 Outstanding Expenses

Outstanding expenses need the following approach to their verification :

- 1) Obtain a certificate from the company that all unpaid and accrued expenses relating to the year have been properly included in respect of items like Wages, Salary, Rent, Interest, Discount, Commission, Electricity Charges, Audit Fee, Legal Expenses, etc.
- 2) Check the respective entries of the Cash Book to verify the actual amount of payment already made on such heads which show outstanding expenses.
- 3) Ensure that all outstanding expenses relating to salary and wages have subsequently been paid at the commencement of the next year.
- 4) Compare all paid and unpaid expenses of the current year with those of the previous year so as to identify any appreciable variations.
- 5) Estimate if the increase or decrease in wages, materials or other expenses is proportionate to the increase or decrease in the turnover.
- 6) Assess the causes of any material change in the rate of gross profit as compared to that of the previous year.

### 7.5.4 Incomes Received in Advance

To verify this item, the auditor should do three things :

- a) Get a schedule of advances received from different parties for specific purposes;
- b) Ensure that incomes received in advance are not included as the incomes of the current year; and
- c) Check that such advances are not omitted from the Balance Sheet.

### 7.5.5 Loans

Verification of loans obtained by the company should be based on the following procedure :

- 1) Check the authority under which loans have been required and procured by the company.
- 2) Examine the various agreements and correspondence relating to the loans.
- 3) Show in the Balance Sheet whether the loans are secured against mortgage of any property.
- 4) Get confirmation from the parties regarding the amount of the loan outstanding at the date of the Balance Sheet, interest due and security offered.
- 5) Refer to the Memorandum and Articles of Association of the company in the context of their provisions on borrowings.
- 6) Ensure that interest payable on loan has been paid to date or is recorded as unpaid in the books of account.
- 7) See the agreements with the bankers on the terms and conditions of bank overdrafts.

### 7.5.6 Contingent Liabilities

Contingency is a condition or situation the ultimate outcome of which, gain or loss, is known or determined only on the occurrence or non-occurrence of one or more uncertain future events. A contingent liability is a possible liability arising from previous dealings or actions which may not be a legal obligation in the future.

Contingent liabilities should be put to the following verification :

- 1) Check that all such known and unknown possible liabilities which may or may not arise in the future are included as contingent liabilities.
- 2) See that contingent liabilities are shown separately as a footnote to the Balance Sheet.
- 3) Pay particular attention to items like :
  - a) Bills Receivable discounted but not matured
  - b) Unpaid calls on partly-paid shares
  - c) Liabilities under guarantees given by the company
  - d) Claims against the company not acknowledged as debts
  - e) Arrears of dividend on cumulative preference shares
  - f) Pending legal actions or undisposed claims
- 4) Examine if some of these liabilities need any provision to be made in the books of account and the amount to be specifically reserved for the possible losses.
- 5) Refer to the Directors' Minute Book and correspondence with the legal advisors of the company.
- 6) Get the required additional information from the officials of the company and judge the true nature of liabilities to be treated as contingent liabilities for the year.

## 7.6 LET US SUM UP

It is the duty of the auditor to ensure that the financial statements of the company show a true and fair view of the state of affairs of the business for the period under review. Any mistake either in the quantum or value of an asset, or in including or excluding a liability, means that both the Profit and Loss Account and the Balance Sheet give a position which is quite different from the real financial position of the company.

Our study in this unit allows us to develop the following guidelines for **Verification and Valuation of Assets and Liabilities**

- 1) Investments : All investments are to be checked with their schedule and they should be valued at their cost price or market price whichever is lower.
- 2) Cash in Hand : There should be surprise visits for cash counts, the balance in hand should be kept at the minimum possible limit, and all cash

- receipts and payments must be duly authorised and supported by proper evidence.
- 3) Cash at Bank : Difference between the Cash Book and Pass Book balances should be periodically reconciled and necessary adjustments should be made for all outstanding bank transactions.
  - 4) Book Debts : Direct confirmation from debtors, checking year-end receipts and examining the amount being transferred to bad and doubtful debts account need proper audit attention.
  - 5) Bills Receivable : All unpaid bills in hand likely to mature after the current year and which have not been discounted as yet are included in the final balance needs audit confirmation.
  - 6) Loans and Advances : Authority under which such loans and advances are granted, system devised to recover the dues as per the mutually agreed schedule of payments and confirmation of the parties in respect of the balances shown against them at the date of the Balance Sheet need consideration.
  - 7) Stock-in-Trade : Methods and frequency of stock taking, consistency and adequacy of the basis of valuation of closing stock, responsibility with which the management has been protecting the safety and security of Stock-in-Trade, and the application of accepted principles of accounting to record the transactions relating to stock demand proper evaluation.
  - 8) Trade Creditors : Check the schedule of creditors prepared by the company as on the date of the Balance Sheet, obtain a direct confirmation from the creditors in respect of substantial outstanding balances and examine the possibilities of payments shown in books but not actually made to parties.
  - 9) Bills Payable : All unpaid bills on the date should be verified with the help of the corresponding schedule and books of account.
  - 10) Outstanding Expenses : Expenses payable but not paid, i.e. payments due but not made are shown as a liability. This, however, should be written off as soon as the payments are made possibly at the beginning of the next year. The company should have a statement and certificate of such outstanding expenses which should be checked by the auditor.
  - 11) Incomes Received in Advance : A schedule of all such incomes which have not accrued but are received during the year should be prepared by the company and checked by the auditor.
  - 12) Loans : Borrowings made by the company should be examined in respect of their purpose, amount, authority, limit and arrangements made for the payment of interest and repayment of principal.
  - 13) Contingent Liabilities : Possible liabilities which are uncertain as on the date of the Balance Sheet either because they have not been admitted by the company as liabilities or the parties have not been able to establish their claims in respect of those items are to be shown as an information by way of a footnote in the Balance Sheet.

### 7.7 KEY WORDS

**Accrued Income** : Income due but not received.

**Broker** : A middleman between the buyer and seller usually charging for his services from both the parties.

**Circularisation** : Issue of a circular letter addressed to the selected parties containing a uniform message.

**Debenture** : A form of corporate security used for borrowing funds at specified rate of interest and date of maturity.

**Disclosure** : Required information to be shown in the Balance Sheet in the specified manner.

**Dividend** : Profit per share declared by a company for its shareholders.

**Evidence** : A relevant or reliable voucher, document, deed, correspondence or situation.

**Interest** : The fixed rate at which payment has to be made or received on loans, advances or deposits.

**Irrecoverable Debt** : Dues which are found to be difficult in recovery despite the best efforts.

**Pass Book** : A record of transactions in the Bank Account of the party as per the bank ledger.

**Stock Exchange** : A recognised market where securities are sold and purchased at the prevailing price through brokers.

### 7.8 ANSWERS TO CHECK YOUR PROGRESS

- A 1 (i) Equity Shares (ii) Debentures (iii) Bonds  
 2 (i) Dividend (ii) Interest (iii) Bonus  
 3 (i) Cost Price (ii) Face Value (Par Value) (iii) Market Price  
 4 (i) Public Issues (Primary Market) (ii) Stock Exchange (Secondary Market) (iii) Individual Transfers (Personal Negotiation)
- B 5 (i) Cash Count (ii) Dangerous (Unsafe) (iii) Reconciliation (iv) Bad Debt (v) Contingent Liabilities
- C 2 (i) True (ii) False (iii) False (iv) False

### 7.9 TERMINAL QUESTIONS

- 1) Discuss the process of verification and valuation of investments in a company.
- 2) Explain the methods of verification of Cash in Hand and Cash at Bank.
- 3) How can the auditor ascertain the correctness of Book Debts shown in the Balance Sheet of a company?
- 4) State the system of verification and valuation of Loans and Advances.
- 5) Give an explanatory note on the problems of verification and valuation of Stock-in-Trade.
- 6) Discuss, with the help of examples of items appearing in the Balance Sheet of a company, how an auditor conducts verification of liabilities.

**Note:** These questions will help you to understand the unit better. Try to write answers for them, but do not submit your answers to the University. These are for your practice only.

### SOME USEFUL BOOKS

Porwal & Kappor, *Auditing, Theory and Practice*, Kitab Mahal, Allahabad, (Chapters 9-12).

Saxena R. G. *Principles of Auditing*, Himalaya Publishing House : Bombay, (Chapters 6-9)

Sharma Dr. T. R. *Auditing*, Shaitya Bhawan; Agara, (Chapter 4, 5 & 6)

Kamal Gupta and Ashok Arora, *Fundamentals of Auditing* Tata McGraw-Hill Publishing Co. Ltd., New Delhi (Chapter 8 to 18).

---

## UNIT 8 COMPANY AUDITOR

---

### Structure

- 8.0 Objectives
- 8.1 Introduction
- 8.2 Need for a Company Auditor
- 8.3 Qualifications of a Company Auditor
- 8.4 Disqualifications of a Company Auditor
- 8.5 Appointment of an Auditor
  - 8.5.1 First Auditor of a Company
  - 8.5.2 Reappointment of Auditors
- 8.6 Removal of an Auditor
- 8.7 Status of the Auditor
- 8.8 Rights and Duties of a Company Auditor
  - 8.8.1 Rights
  - 8.8.2 Duties
  - 8.8.3 Some Legal Decisions
- 8.9 Auditing Standards
- 8.10 Let Us Sum Up
- 8.11 Key Words
- 8.12 Answers to Check Your Progress
- 8.13 Terminal Questions

---

### 8.0 OBJECTIVES

---

After studying this unit, you should be able to :

- appreciate the need for auditors in the company
- understand the difference between partnership audit and company audit
- identify the statutory position of a company auditor
- explain the essential steps before the commencement of audit.

---

### 8.1 INTRODUCTION

---

You have learnt the fundamental concepts of auditing like internal control, vouching, verification and valuation. These concepts are applicable to the audit of all types of business organisations. But you know that audit of concerns other than companies is voluntary and not obligatory. But, in case of a company, the audit is compulsory under the provisions of the Companies Act. Hence, auditor's appointment, his powers, his duties, etc., are governed by rules given in the Act. In this unit you will learn the rules relating to the qualifications, appointment, powers and duties of a company auditor in detail.

---

### 8.2 NEED FOR A COMPANY AUDITOR

---

The main purpose of appointing an auditor or auditors in a company is to safeguard the interests of the shareholders because, for every shareholder, it is neither possible to inspect the books of account of the company personally nor to participate in its management actively. An auditor, therefore, is a representative of the shareholders and he works on their behalf. He is to ensure that the directors have maintained proper books of account, the accounting records are correct and genuine, the company has complied with the provisions of the Companies Act and that nothing has been done to jeopardise the interests of the shareholders deliberately.

When the auditor reports to the shareholders expressing satisfaction, his opinion serves as an assurance that everything relating to accounts is in order in the company. He is primarily to protect the rights of the shareholders. Those who are responsible for the management of its affairs must not work against the interests of the shareholders either in using the assets of the company or in distributing the dividend. An auditor, therefore, has to exercise reasonable amount of care and skill in his job because the shareholders rely primarily upon his opinion in this regard. If there is any irregularity in the books of account, or something is being done in the company which is illegal and improper, this will adversely affect the interests of the shareholders. Hence, the auditor should report all such cases of irregularity to the shareholders. The main responsibility of an auditor is to examine the books of account of the company as maintained by its officers and to report to the shareholders that the financial position of the company as represented by its balance sheet gives a true and fair view of its state of affairs.

### 8.3 QUALIFICATIONS OF A COMPANY AUDITOR

According to Section 226(1) and (2) of the Companies Act, 1956, the prescribed qualifications of a company auditor are as follows:

- 1 A person shall not be qualified for appointment as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. Provided that a firm whereof all the partners practising in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of a company, in which case any partner so practising may act in the name of the firm.
- 2 A person who holds a certificate under the Restricted Auditor's Certificate Rules, 1956, is also qualified to act as an auditor of company. Such persons are called certified auditors and are always subject to the rules made in this behalf by the Central Government.

### 8.4 DISQUALIFICATIONS OF A COMPANY AUDITOR

Section 226(3) of the Act further provides that the following are not qualified for appointment as a company auditors:

- a) A body corporate
- b) An officer or employee of the company
- c) a person who is a partner, or who is in the employment, of an officer or employee of the company.
- d) a person who is indebted to the company for an amount exceeding Rs. 1000, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding, Rs. 1000.

Moreover, if a person is appointed as company auditor and subsequently becomes disqualified, he is deemed to have automatically vacated his office as auditor of the company from the date of his disqualification.

#### Rationale for Restrictions

You have noted here that some statutory restrictions have been imposed on the appointment of an auditor in a company in respect of his qualifications. The reasons for such restrictions are as follows:

- 1 The process of auditing involves an independent examination of accounts to ensure that they are free from errors or frauds. This is a professional responsibility expecting expertise as well as integrity.
- 2 An efficient performance of duties by a company auditor is an equally important aspect of law. He is, therefore, under the discipline of a recognised professional accountancy body, i.e., Institute of Chartered Accountants of India.

- 3 A company auditor needs legal protection as well as the support of an organised professional body in discharging his duties in an independent manner.
- 4 Unbiased attitude and impartial judgement are necessary for a company auditor both in verification of accounts and in expression of his opinion on the financial statements of the company.
- 5 Undue connection or association of a company auditor with the directors or officers of the company either as a partner or as an employee defeats the very purpose of auditing and the concept of independence.

### 8.5 APPOINTMENT OF AN AUDITOR

Let us now discuss the rules relating to the appointment of auditors in a company. Section 224 of the Companies Act provides: "Every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting and shall, within seven days of the appointment, give intimation thereof to every auditor so appointed".

If you translate this provision into rules of appointment of a company auditor, these will be as follows:

- 1 A company auditor is normally appointed at the annual general meeting of the company.
- 2 The tenure of appointment of a company auditor is from one annual general meeting to another.
- 3 That when an auditor is appointed in a company, he should be intimated about it within seven days of such appointment.

Besides these three basic rules for the appointment of a company auditor, the supplementary considerations are:

- 1 that a written certificate and consent should be obtained from the proposed auditor before his appointment is finalised by the company;
- 2 that in case a company is unable to appoint an auditor at its annual general meeting, the central government has the powers to make such an appointment to fill the vacancy;
- 3 that no one is appointed as a company auditor who holds such appointment in twenty companies at a time; and
- 4 that the appointed auditor should communicate to the Registrar of Companies, within thirty days of the receipt of intimation from the company, whether he accepts or refuses to accept the appointment.

#### 8.5.1 First Auditor of a Company

You know that a company may be registered any time during the year and, therefore, its date of registration may differ from the date of commencement of its normal accounting year. Hence, the company shall also need an auditor for that partial period of its operation which precedes the normal accounting year. The auditor to be appointed for this initial and partial period of the company is known as the first auditor. Such appointments are made by taking into consideration the following factors:

- a) The first auditor or auditors of a company are appointed by the Board of Directors of the company
- b) Such appointment is to be made within one month of the date of registration of the company.
- c) The first auditor will hold office until the conclusion of the first annual general meeting of the company.

### 8.5.2 Reappointment of Auditors

A statutory auditor is not appointed on a permanent basis. It is normally an annual assignment. It may, however, be renewed and extended for another term. When the previous auditor of the company is allowed to continue for the next year, it is considered as a **reappointment**.

Under normal circumstances, a retiring auditor is reappointed as a company auditor. In some cases, however, this may not be so owing to the following reasons:

- 1 The auditor is now not qualified for reappointment;
- 2 The auditor has expressed his unwillingness to be reappointed by giving the company a notice in writing about his intention to discontinue.
- 3 The company has passed a resolution at the general meeting to appoint somebody else as the company auditor, or not to reappoint the retiring auditor; or
- 4 Notice has been given of an intended resolution to appoint some person or persons in the place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person or of all those persons, the resolution cannot be proceeded with.

### 8.6 REMOVAL OF AN AUDITOR

An Auditor of a company can be removed from office before the expiry of his term in the following manners:

- a) When the company takes such decision at its general meeting;
- b) By an ordinary resolution of which special notice has been given; and
- c) After obtaining the previous approval of the central government.

The first auditors of a company appointed by its Board of Directors can be removed at a general meeting by an ordinary resolution of which a special notice is given.

Thus you see that in all matters relating to appointment, reappointment, removal or retirement of an auditor, the shareholders of the company play an important role. This once again establishes the fact that the auditor is responsible to the shareholders. He acts on their behalf, and not on behalf of the directors. He is shareholders' representative and his statutory duties are to safeguard their interest.

There is one more process of protection given to auditors against their undue removal. If an auditor other than the retiring auditor is to be appointed, special notice must be given to the company by a member before the annual general meeting. A copy of this notice must be sent to the retiring auditor as well as to all members prior to the general meeting. The retiring auditor, after getting a copy of the notice, may make a written representation to the company and ask the company to circulate it among the members of the company. Besides, the retiring auditor has the power to attend the annual general meeting at which the proposal for his removal is being considered and to address the members.

### 8.7 STATUS OF THE AUDITOR

Now the question arises as to what is the real status of an auditor in a company. Obviously, an auditor enjoys a legal status. In other words, a company auditor is a statutory auditor, because he is appointed strictly in accordance with the provisions of the law. The status of an auditor in a company is governed by the following principles:

- 1 **An agent:** The auditor is an agent of the members of the company appointed to perform duties as laid down by (a) the Companies Act, (b) the Articles of Association of the company, and (c) the audit agreement between the auditor and the client.
- 2 **Not an Advisor:** An auditor is not an advisor to the company. It is not a part of his duty to advise the directors or shareholders.

- 3 **Not a Detective:** An auditor is neither a detective nor an employee of the company. He is a watchdog and not a bloodhound. He need not be unduly suspicious in his job.
- 4 **Not to Discover Frauds:** it is not the responsibility of the auditor to discover frauds which have been carefully perpetrated. He can rely upon the honesty of the employees of the company who enjoy a position of confidence in the organisation.
- 5 **Not a Guarantee:** An auditor's opinion on the financial statements of the company does not mean an automatic guarantee of correctness of books of account.
- 6 **An Officer:** Although an auditor is not an employee of a company, he is treated as an officer of the company under various provisions of the Companies Act.

#### Check Your Progress A

- 1 What is the main purpose of appointing an auditor in a company?  
.....  
.....  
.....
- 2 Who may be appointed as a company auditor?  
.....  
.....
- 3 What is the difference between the appointment and reappointment of auditors in a company?  
.....  
.....  
.....
- 4 State whether the following statements are True or False:
  - i) Once a good auditor has been appointed in a company, he may normally continue for five years.
  - ii) If the directors do not get cooperation of the auditors, they can change him before the expiry of his term.
  - iii) The auditors must be impartial and unbiased in their judgement.
  - iv) Since the auditor is a shareholders' representative, he must ensure that they get the highest dividend.
  - v) Every company auditor is a chartered accountant but every chartered accountant cannot be an auditor of a company.

### 8.8 RIGHTS AND DUTIES OF A COMPANY AUDITOR

#### 8.8.1 Rights

The Act provides for the following rights to the auditors of a company:

- 1 **Rights of access to books of accounts:** Every auditor of a company shall have a right of access at all times to the books of account and vouchers of the company, whether kept at the head office or elsewhere. The books include not only the financial books of the company but also the statutory and statistical books.

- 2 **Rights to obtain information and explanation:** The auditor is entitled to require from the officers of the company such information and explanations as he may think necessary for the performance of his duties as auditor.
- 3 **Right to receive notices and attend general meetings:** According to Section 231 of the Act, the auditor has a right (a) to receive all notices and other communications relating to any general meeting of the company; (b) to attend any general meeting of the company; and (c) to be heard on any part of the business which concerns him as an auditor at any general meeting.
- 4 **Right to make corrections in the financial statements:** The auditor is requested to conduct an independent examination of the books of account of a company and report to the shareholders whether the financial statements show a true and fair view of the state of affairs of the company. Hence, if he finds some fault, he has the right to make the necessary corrections. If his suggestions are not carried out, he has the right to refer the matter in his report.
- 5 **Right to visit branches:** Where the branch accounts are not audited by a qualified auditor, the company auditor has a right of access at all times to the books of accounts and vouchers of the company as maintained at the branch office and may visit the branch of the deems it necessary.

### 8.8.2 Duties

The duties of a company auditor can be divided into three categories (1) duties relating to audit report, (2) duties relating to enquiry, and (3) other statutory duties. Let us now discuss them one by one.

#### 1 Duties relating to Report

The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss account and on every other document declared by this Act to be part of or annexed to the balance sheet or profit and loss account, which are laid before the company in general meeting during his tenure of office. The report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Act in the manner so required and give a true and fair view.

- i) in the case of the Balance Sheet, of the state of the company's affairs as at the end of its financial years; and
- ii) in the case of the Profit and Loss Account, of the profit or loss for its financial year.

#### The Auditor's report shall also state

- a) Whether he has obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purpose of his audit;
- 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 has been received from branches not visited by him; and
- c) whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

#### 2 Duties relating to Enquiry

The auditor should specifically enquire into the following six matters:

- i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company.
- ii) Whether the transactions which are not supported by any facts or evidence, though recorded in the books, are not prejudicial to the interests of the company.

- iii) Where the company is not an investment company or a banking company, whether it has sold any shares, debentures or other securities at a price which is lower than the price at which they were purchased by the company.
- iv) Whether loans and advances made by the company have been shown as deposits.
- v) Whether any personal expenses have been charged to revenue accounts of the company.
- vi) Where the books of the company show that shares have been issued for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been received, whether the position as stated in the books and the Balance Sheet is correct, regular and not misleading.

#### 3 Other Statutory Duties

- i) The prospectus issued by an existing company should contain an auditor's report regarding (a) profit and losses, (b) assets and liabilities, (c) rate of dividends paid for each of the five financial years preceding the issue of the prospectus. Hence it is the duty of auditor to submit such report.
- ii) The auditor has to certify a statutory report.
- iii) The auditor has to sign his report.
- iv) Where an inspector is appointed by the Central Government to investigate the affairs of the company, it is the duty of the auditor to give him all assistance in the investigation.
- v) When a company goes into voluntary winding up and a declaration of solvency is made by the directors, the auditor shall submit his report on the Profit and Loss Account and the Balance Sheet.

**It is important to note here that the rights and powers of auditors cannot be limited or abridged either by the Articles of Association or by the directors or shareholders of the company.**

### 8.8.3 Some Legal Decisions

You are now familiar with the powers and duties of auditors. The following legal decisions further highlight the role of the auditors in discharging their statutory responsibilities:

- 1 It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the Balance Sheet, but to see that it is a true and accurate representation of the company's affairs. (*Leeds Estate Building and Investment Co. vs. Shepherd, 1887*)
- 2 An auditor must be honest, that is, he must not certify what he does not believe to be true and he must take reasonable care and skill before he believe that what he certifies is true. (*London and General Bank, 1895*).
- 3 It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case (*Kingston Cotton Mills Co. Ltd., 1896*).
- 4 The auditor undoubtedly does undertake very considerable responsibilities, and is liable for the proper discharge of his duties, and if by the neglect of his duties or by want of reasonable care he neglects his duty, and damage is caused to the company as such, he is responsible for that damage (*London Oil Storage Co. Ltd. vs. Seear, Hasluck & Co., 1904*).
- 5 When the reports of the auditors are not communicated to the shareholders, directors are responsible for this lapse. Auditor's duties are discharged when their reports are delivered to the company. It is the duty of the directors to summon the shareholders' meeting and to see that the report of the auditors is read at the meeting. (*Allen. Craig & Co. Ltd. 1934*).

- 6 The vital task of the auditor is to ensure that errors are not made. He must carry out this task with an enquiring mind and not with suspicion of honesty. He should proceed with his work suspecting that someone might have made a mistake somewhere and that a check must be made to ensure that there has been none. (*Fomento Ltd. vs. Selsdon Fountain Pen Co. Ltd., 1958*).

**Check Your Progress B**

- 1 Tick (✓) the correct answer
- i) Auditors in a company must be independent because:
    - a) their sole obligation is to submit a report to third parties.
    - b) they must adopt a critical attitude during the audit.
    - c) they must be without bias with regard to the company under audit
    - d) they may have a direct interest in the business of the company.
  - ii) Credibility of accounts expects an independent audit for the readers of financial statements of a company so that:
    - a) the financial data included in the statements are measured and communicated correctly.
    - b) an opportunity may be given for an objective examination of and reporting on statements prepared by the management.
    - c) the management of the company may be congratulated on its achievement of good performance.
    - d) accuracy of information contained in the financial statements may be certified.
  - iii) When a statutory auditor expresses an opinion on financial statements, his responsibilities extend to:
    - a) whether the results of the company's operating decisions are fairly presented in the financial statements.
    - b) the underlying wisdom of the client's management decisions.
    - c) active participation in the implementation of the advice given to the company
    - d) an ongoing responsibility for the solvency of the company.
  - iv) If the audit tests show that the management of the company has perpetrated international irregularities in accounts of the company, the auditor's duty should be :
    - a) to ignore it because it is not a material nature.
    - b) to take note of the irregularities for future audits.
    - c) to caution the management not to repeat such irregularities.
    - d) to obtain further explanation, investigate the effects of irregularities, qualify the report and inform the shareholders.

- 2 State three main rights a company auditor.
- .....
- .....
- .....

**8.9 AUDITING STANDARDS**

It may be of interest to you that international standards also guide the role of auditors. Their approach to company audit is now based on the following professional guidelines:

- 1 An audit is the independent examination of, and expression of opinion on, the financial statements of a company by an appointed auditor in pursuance of that appointment and in compliance with relevant statutory obligation.
- 2 The responsibility for the preparation of the financial statements and the presentation of the information included therein rests with the directors of the company. The auditor's responsibility is to report on the financial statements as presented by the management.
- 3 The auditor should adequately plan, control and record his work.
- 4 The auditor should ascertain the company's system of recording and processing transactions and assess its adequacy as a basis for the preparation of financial statements.
- 5 The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom.
- 6 If the auditor wishes to place reliance on any internal controls, he should ascertain and evaluate those controls and perform compliance tests on their operation.
- 7 The auditor should carry out such a review of the financial statements as is sufficient, in conjunction with the conclusions drawn from the other audit evidence obtained, to give him a reasonable basis for his opinion on the financial statements.

The normal expectation from the auditor, therefore, is to express an independent judgement on the results and financial position of the company, free from any pressure which the management or owners of that company might seek to exert.

**8.10 LET US SUM UP**

Auditors are appointed in a company to examine the books of account and to report to the shareholders whether a true and fair view of the state of affairs is represented by the financial statements.

The difference between the audit of a partnership firm and of a company are in respect of (i) legal compulsion, (ii) purpose of audit, (iii) statutory position, (iv) liabilities for negligence, (v) audit fee, (vi) form of reporting, (vii) scope of examination, (viii) define responsibility, (ix) remuneration fixation, (x) verification assignment, (xi) conceptual identification, and (xii) articles and memorandum.

Only chartered accountants qualify for appointment as a company auditor. Their appointment is normally made at the annual general meeting of the company. A retiring auditor may be reappointed as a company auditor provided he is not disqualified for the appointment or has not shown his unwillingness to continue. In case an auditor is to be removed from office before the expiry of his term, prior approval of the Central Government should be obtained and on ordinary resolution with special notice should be passed at the general meeting of the company.

An auditor is an agent of the shareholders of the company but he is neither a financial advisor nor a detective. The statutory rights of a auditor are : (i) access to books of account, (ii) obtain necessary information and explanation, (iii) attend general meeting, (iv) make necessary correction in financial statements, and (v) visit branches, if needed. His duties can be classified as (a) those relating to reports, (b) those relating to enquiry, (c) and other statutory duties. Certain legal decisions are also relevant in determining the role of auditors in discharging their statutory responsibilities.

Commencement of the audit of a company involves many preliminaries. He has to (a) make sure that his appointment is in order, (b) obtain a letter of engagement, and (c) acquaint himself with articles, memorandum, scope of work, system accounting, system of internal control, etc. For the whole audit assignment he must follow the normal procedure of audit, the relevant statutory provisions and the guidelines of international auditing standards.



## 8.11 KEY WORDS

**Audit Planning :** What to do, how to do, who will do and how to do the audit work?

**Audit Report :** A report to the members of the company on the accounts and financial statements stating whether they give a true and fair view of the state of the company's affairs for the financial year.

**Auditing Standard :** International guidelines to promote uniformity and consistency in audit practices.

**First Auditor :** The auditor appointed by the Board of Directors of the company within one month of incorporation.

**New Audit :** Either the first audit of a company or the subsequent audit of the company by a new auditor.

**Partnership Audit :** Audit of a partnership form of business organisation by an appointed auditor.

**Statutory Auditor :** An Auditor appointed after the first auditor at an annual general meeting of the company.

**Subsequent Auditor :** Auditor appointed after the first auditor at an annual general meeting of the company.

**True and Fair View :** The auditor reports whether the financial statements represent fairly the actual financial position of the company as at the end of the accounting period and the profit or loss for that period.

**Statutory Audit :** A report presented before the Statutory meeting of a company. It contains detailed information relating to the formation of the company including shares allotted receipts and disbursements, directors, etc.

## 8.12 ANSWERS TO CHECK YOUR PROGRESS

- A 4 i) False    ii) False    iii) True    iv) False    v) True  
 B 1 i) c        ii) b        iii) a        iv) d

## 8.13 TERMINAL QUESTIONS

- 1 Discuss the position of an auditor in a company under the provisions of the Companies Act.
- 2 State the qualifications and disqualifications of the auditor for a company.
- 3 Explain how an auditor may be (a) appointed, (b) reappointed, and (c) removed in a company.
- 4 What is the status of the auditor in a company? How can be protect the rights of the shareholders of the company?
- 5 Briefly analyse the powers and duties of company auditors.
- 6 What are the statutory duties of a company auditor? Discuss in detail.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

## UNIT 9 COMPANY AUDIT-I

### Structure

- 9.0 Objectives
- 9.1 Introduction
- 9.2 Difference Between Partnership Audit and Company Audit
- 9.3 Commencement of Audit
  - 9.3.1 Letter of Engagement
  - 9.3.2 Preliminaries
  - 9.3.3 Role of Company
- 9.4 Audit of Share Capital
  - 9.4.1 Shares Issued for Cash
  - 9.4.2 Shares Issued for Consideration Other than Cash
- 9.5 Shares Issued at a Premium
- 9.6 Shares Issued at a Discount
- 9.7 Audit of Calls
  - 9.7.1 Calls in Arrears
  - 9.7.2 Calls in Advance
- 9.8 Forfeiture and Reissue of Shares
- 9.9 Issue and Redemption of Preference Shares
- 9.10 Issue of Bonus Shares
- 9.11 Alteration of Share Capital
- 9.12 Reduction of Share Capital
- 9.13 Issue of Share Certificates
- 9.14 Share Transfer Audit
- 9.15 Presentation and Disclosure of Share Capital
- 9.16 Let Us Sum Up
- 9.17 Key Words
- 9.18 Answers to Check Your Progress
- 9.19 Terminal Questions

## 9.0 OBJECTIVES

After studying this unit, you should be able to:

- distinguish between partnership audit and company audit
- describe the audit procedure of shares issued for cash or for consideration other than cash
- explain rules for issue of shares at a premium and issue of shares at a discount
- describe the audit procedure for calls in arrears and verification of forfeited shares
- explain audit of issue and redemption of preference shares
- explain the audit of alteration of share capital
- list steps involved in share transfer audit
- describe the manner of presentation and disclosure of share capital in financial statements of the company.

## 9.1 INTRODUCTION

In Unit 8 you learnt about the qualifications, appointment and status of an auditor and also about his rights and duties. In this unit you will learn first of all, that before the commencement of the audit of a company, the auditor must fulfil certain preliminary steps. Particularly, the auditor must acquaint himself with (i) articles and memorandum of association to verify the constitution and powers under which the company operates, (ii) system of internal control, and (iii) other relevant provisions of the Companies Act,

## 8.11 KEY WORDS

**Audit Planning:** What to do, how to do, who will do and how to do the audit work?

**Audit Report:** A report to the members of the company on the accounts and financial statements stating whether they give a true and fair view of the state of the company's affairs for the financial year.

**Auditing Standard:** International guidelines to promote uniformity and consistency in audit practices.

**First Auditor:** The auditor appointed by the Board of Directors of the company within one month of incorporation.

**New Audit:** Either the first audit of a company or the subsequent audit of the company by a new auditor.

**Partnership Audit:** Audit of a partnership form of business organisation by an appointed auditor.

**Statutory Auditor:** An Auditor appointed after the first auditor at an annual general meeting of the company.

**Subsequent Auditor:** Auditor appointed after the first auditor at an annual general meeting of the company.

**True and Fair View:** The auditor reports whether the financial statements represent fairly the actual financial position of the company as at the end of the accounting period and the profit or loss for that period.

**Statutory Audit:** A report presented before the Statutory meeting of a company. It contains detailed information relating to the formation of the company including shares allotted receipts and disbursements, directors, etc.

## 8.12 ANSWERS TO CHECK YOUR PROGRESS

A 4 i) False    ii) False    iii) True    iv) False    v) True  
B 1 i) c        ii) b        iii) a        iv) d

## 8.13 TERMINAL QUESTIONS

- 1 Discuss the position of an auditor in a company under the provisions of the Companies Act.
- 2 State the qualifications and disqualifications of the auditor for a company.
- 3 Explain how an auditor may be (a) appointed, (b) reappointed, and (c) removed in a company.
- 4 What is the status of the auditor in a company? How can he protect the rights of the shareholders of the company?
- 5 Briefly analyse the powers and duties of company auditors.
- 6 What are the statutory duties of a company auditor? Discuss in detail.

**Note:** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

## UNIT 9 COMPANY AUDIT-I

### Structure

- 9.0 Objectives
- 9.1 Introduction
- 9.2 Difference Between Partnership Audit and Company Audit
- 9.3 Commencement of Audit
  - 9.3.1 Letter of Engagement
  - 9.3.2 Preliminaries
  - 9.3.3 Role of Company
- 9.4 Audit of Share Capital
  - 9.4.1 Shares Issued for Cash
  - 9.4.2 Shares Issued for Consideration Other than Cash
- 9.5 Shares Issued at a Premium
- 9.6 Shares Issued at a Discount
- 9.7 Audit of Calls
  - 9.7.1 Calls in Arrears
  - 9.7.2 Calls in Advance
- 9.8 Forfeiture and Reissue of Shares
- 9.9 Issue and Redemption of Preference Shares
- 9.10 Issue of Bonus Shares
- 9.11 Alteration of Share Capital
- 9.12 Reduction of Share Capital
- 9.13 Issue of Share Certificates
- 9.14 Share Transfer Audit
- 9.15 Presentation and Disclosure of Share Capital
- 9.16 Let Us Sum Up
- 9.17 Key Words
- 9.18 Answers to Check Your Progress
- 9.19 Terminal Questions

## 9.0 OBJECTIVES

After studying this unit, you should be able to:

- distinguish between partnership audit and company audit
- describe the audit procedure of shares issued for cash or for consideration other than cash
- explain rules for issue of shares at a premium and issue of shares at a discount
- describe the audit procedure for calls in arrears and verification of forfeited shares
- explain audit of issue and redemption of preference shares
- explain the audit of alteration of share capital
- list steps involved in share transfer audit
- describe the manner of presentation and disclosure of share capital in financial statements of the company.

## 9.1 INTRODUCTION

In Unit 8 you learnt about the qualifications, appointment and status of an auditor and also about his rights and duties. In this unit you will learn first of all, that before the commencement of the audit of a company, the auditor must fulfil certain preliminary steps. Particularly, the auditor must acquaint himself with (i) articles and memorandum of association to verify the constitution and powers under which the company operates, (ii) system of internal control, and (iii) other relevant provisions of the Companies Act,

1956 (hereinafter referred to as the Act), affecting financial statements, etc. Then, you already know the general principles of auditing which are applicable normally to all types of entities irrespective of their nature, size and form. The audit procedures like vouching and verification of assets and liabilities as applicable to all entities have duly been dealt with in detail in Block 2. However, certain specific aspects of such as audit of share capital, transfer of shares, audit of dividends, depreciation and reserves that are peculiar to companies etc., were not covered. In this unit, after covering the preliminaries before commencement of the audits of a company we shall primarily deal with audit of share capital which is conducted in order to ensure that the share capital has been issued in accordance with the relevant provisions of the Companies Act, 1956 and properly recorded in the books of account and duly reflected in the balance sheet of the company.

## 9.2 DIFFERENCE BETWEEN PARTNERSHIP AUDIT AND COMPANY AUDIT

Before we take up the preliminaries before commencement of the audit of a company and the audit of share capital and divisible profits etc. let us understand the difference between the partnership audit and company audit.

The difference between the two types of audit is as follows:

COMPANY AUDIT	PARTNERSHIP AUDIT
1 It is legally compulsory for every limited company to get its accounts audited every year.	It is not necessary for a firm to get its accounts audited.
2 The purpose is to satisfy the information needs of the shareholders of the company on whose behalf audit is conducted.	It is mainly to avoid differences or disputes amongst the partners.
3 The Act defines the qualifications, disqualifications, duties, powers and process of appointment of auditor. His statutory powers cannot be limited or taken away by directors or shareholders	The firm may have its own decision in the appointment of auditor, and in determining his qualification, duties and powers.
4 The audit fee for the year must be shown in the Profit and Loss Account of the company	It is not essential for the firm to disclose the amount of audit fee paid to auditors.
5 The Act guides the auditor in respect of the principles and processes of accounting to be followed by the company and the form of reporting to be adopted by him.	The auditor has to refer to the different clauses of the Partnership Deed with regard to the responsibility for maintaining accounts, methods of accounting, profit-sharing ratio of partners, terms of borrowing and the type of audit reporting relevant to the nature of the assignment
6 The auditor is to ensure that the directors of the company present to the shareholders a true and fair view of the state of affairs of the business through the financial statements of the company	The scope of examination and objects of audit are to meet the requirements of the terms of agreement between the auditor and the firm.
7 It is statutory responsibility of a specified and definite nature	The responsibility of the auditor is flexible; he gets clear instructions from the firm with regard to the nature and extent of his work.

8 The remuneration of the auditor is fixed by the appointing authority at the annual general meeting.	The remuneration is fixed by the partners of the firm.
9 The audit assignment is only for verification of books of account and for and for auditor's report thereon.	The audit assignment may include preparing books of account as well.
10 The auditor examines that all transactions of the company are within the framework of its Memorandum of Association and all acts of the directors are duly authorised under its Articles of Association.	The auditor refers to the Partnership Deed for all matters relating to accounts and the ability of the partners in managing the affairs of the firm.

## 9.3 COMMENCEMENT OF AUDIT

Commencement of audit of a company involves two stages:

- 1 When a new company comes into existence and the first auditor is appointed; and
- 2 When the company is already established, but a new auditor is appointed (i.e. the old auditor is substituted by a new auditor) for the subsequent audit of the company.

In the first case, the auditor of a new company has to be a little more careful in making himself conversant with the accounting system and the rules and regulations affecting the company.

In the second case, the new auditor has to follow the professional ethics of obtaining consent of the retiring auditor before accepting his appointment. Although the company is old, the auditor is new to that company. He should, therefore, exercise the same care as would have been necessary in the case of the first audit of the company.

Consideration required at the commencement of a new audit are:

- a) to ensure that the company has followed the statutory provisions in regard to registration, incorporation, allotment and commencement of business;
- b) to refer to the relevant regulations of the company contained in its articles, memorandum or prospectus; and
- c) to confirm that his appointment is in conformity with the Act and the Articles.

### 9.3.1 Letter of Engagement

Once the appointment has been accepted, it is a normal practice to issue a letter of engagement to the company specifying the terms and conditions of the assignment. The auditor should incorporate in the letter the precise scope of work and nature of duties to be performed by him in the company. A letter of engagement, therefore, is a confirmation of acceptance of offer made by the company.

The principal contents of a letter of engagement are:

- a) **The nature of the assignment** — in the case of a statutory audit, it highlights the requirements imposed by the Act which cannot be changed either by the company or auditor and the significance of the audit report;
- b) the way the auditor would normally approach the job, including the **assistance and cooperation** which he expects from the company; and
- c) the **audit fees** to be charged for the purpose.

A copy of the letter of engagement is also sent to the company for signature as an acknowledgement of agreement as to terms. It is then returned to the auditor for his records.

### 9.3.2 Preliminaries

By now you must have seen that audit is a professional assignment which demand its own expertise. Preliminaries before commencement of the audit of a company need the following approach :

- 1 Obtain a clearance from the previous auditor of the company whether there is any professional reason why the audit should not be accepted — this being a **professional etiquette**.
- 2 Ensure that the **appointment** is in conformity with the provisions of the Act.
- 3 Consult the **Articles and Memorandum** of Association with special reference to the clauses affecting accounts and audit.
- 4 Outline the **nature and scope** of work and duties and the time of completion of audit report.
- 5 Examine the **system of accounting** followed by the company and point out the weaknesses, if any.
- 6 Get a **list of books** maintained in the company, persons responsible for maintaining them and their specimen signatures.
- 7 Collect a **list of officers** of the company with their powers, duties and specimen signatures.
- 8 Familiarise with the **technical knowledge** about the company.
- 9 Enquire about the system of **internal control** in practice and evaluate its effectiveness..
- 10 Ask for a copy of the **audited balance sheet** and auditor's report of the company for the previous year.
- 11 Advise the company to **complete the accounting records**, balance the books prepare the final accounts, arrange the vouchers serially, and prepare schedules of different categories of debtors and creditors.
- 12 Identify the **events and transactions** likely to have a significant effect on the financial statements of the company.
- 13 Design the nature and extent of **audit tests** appropriate to the company.

Although the exact manner of conducting audit largely depends upon the size and nature of the company, a systematic approach is essential to achieve the audit objectives. Moreover, the different aspects of audit work are closely interrelated. Hence, it is useful to distinguish between the essential phases through which the audit work proceeds and progresses in the company.

### 9.3.3 Role of Company

At the time of commencement of audit, the company must also be ready to extend its cooperation to the auditor. Besides other arrangement, the company's approach to audit should be on the following lines:

- 1 Keep a correct record of the day-to-day transactions of the business.
- 2 Maintain documentary and other evidences in support of the transactions in proper sequence to facilitate their audit reference.
- 3 Obtain bank statements periodically and reconcile them with the cash records of the company.
- 4 Compile a list of debtors and creditors of different categories showing the amount in respect of each.
- 5 Record all important decisions pertaining to financial matters, preferably in the form of resolutions.
- 6 Arrange all relevant communications issued or received by the company affecting accounting records.

- 7 Provide necessary informations and explanations which may be required by the auditor in course of his preliminary evaluation.
- 8 Prepare supplementary statements or additional reports relating to significant transactions as a basis to information to the auditor.

The effectiveness and promptness of audit is virtually a joint responsibility of the company and its auditor. Their mutual cooperation and understanding, therefore, help the process of audit.

## 9.4 AUDIT OF SHARE CAPITAL

The audit of share capital assumes significance particularly in the first year itself since a company raises share capital immediately after incorporation and subsequently, in the later years when it decides to further raise its share capital. In the intervening years, the auditor may perform routine checks to verify authorised, issued and subscribed share capital.

An issue of share capital involves three stages, namely, the application stage, the allotment stage and the call stage. However, a company is also required to comply with a number of requirements before actually going for public subscription. In this context, the auditor should:

- 1 Study the conditions of issue contained in the Memorandum and Articles of Association, Prospectus or Statement in lieu of Prospectus, and examine whether all of them have fully been complied with.
- 2 Verify that the first allotment had not been made until the amount of minimum subscription stated in the Prospectus had been subscribed and that until then the amount received was kept deposited in a scheduled bank.
- 3 Confirm that the brokerage and underwriting commission had been paid only at the rates authorised by the prospectus or the Articles of Association.
- 4 Verify that preliminary contracts, if any, for purchase of a property or business, for creating an organisation for management of the company, etc. had been carried out strictly according to the terms stated in the prospectus.
- 5 Ensure that the company intending to offer shares to the public for subscription by the issue of a prospectus had, before such issue, made an application to one or more recognised stock exchanges for permission for the shares intending to be so offered within the stock exchanges or each exchange.
- 6 Confirm that the guidelines issued by the Securities and Exchange Board of India (SEBI) had been duly followed.

Having taken the above steps, the auditor may specifically examine

- i) shares issued for cash and
- ii) shares issued for consideration other than cash, if any.

### 9.4.1 Shares Issued for Cash

As stated earlier, there are three stages in the issue of shares for cash viz., application stage, allotment stage and calls stage. Each stage has its own peculiarities and involves the following steps for their audit.

#### Application Stage

- i) Check entries in the Application and Allotment Sheets with the original applications;
- ii) Check entries in the Application and the Allotment sheets as regards deposits of money, received with the applications, with those in the Cash Book;
- iii) Check that the application money was deposited in a scheduled bank till the grant of the 'Certificate to Commence Business'.

- iv) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;
- v) Check the totals columns in the Application and Allotment Sheets and confirm the journal entries.
- vi) Examine that the issue is within the limits authorised by the Memorandum and Articles of Association.

#### Allotment Stage

- i) Examine Director's Minutes Book to verify approval of allotments.
- ii) Compare copies of letters of allotment with entries in the Application and Allotment Book.
- iii) Trace entries in the Cash book and the Application and Allotment Sheets for the verification of amounts collected on allotment.
- iv) Check totals of amounts payable on allotment and verify the journal entries.
- v) Examine whether relevant requirements of Reserve Bank of India have been complied with in case of allotment to non-residents.
- vi) Verify that the amount of the shares allotted do not exceed the authorised or nominal capital of the company.
- vii) Check that the return of allotment have been filed with the Registrar of Companies.

#### Calls Stage

- i) Examine the Director's resolution making the call.
- ii) Vouch amounts received with the counterfoils of receipts.
- iii) Verify the journal entry, debiting the Call Account and crediting Share Capital with totals of the amounts due.
- iv) Compare the application and allotment books with the schedule of calls in arrears showing the difference between calls due and calls received.
- v) Check the calls received in advance either in the cash book or through the journal are transferred to a separate account.

### 9.4.2 Shares Issued for Consideration other than Cash

Shares may also be issued for consideration other than cash. Such instances may arise where a company issues shares to vendors of business against purchase consideration; to promoters who have borne preliminary expenses, to underwriters against settlement of under-writing commission, etc. The audit procedure followed in this regard involves the following:

- 1 Examine the contract under which shares have been allotted for consideration other than cash. In case of purchase of property or business, the contract will show the amount of purchase consideration. In case shares have been issued as remuneration to underwriters for services rendered by them, the auditor should ascertain the terms and conditions of payment from the contract with them. Where shares have been issued to promoters, the contract with them should be examined to ascertain the nature of consideration.
- 2 Examine the prospectus for details as to the amount payable to vendors, underwriters and promoters, and the mode of payment.
- 3 Refer to Board of Directors' Minutes Book and check whether the resolution was passed by the directors for allotment of shares to vendors, underwriters, promoters, etc.
- 4 Check the journal entries concerning the issue of shares for consideration other than cash.

- 5 Verify that a copy of the contract as required by Section 75(9)(b) of the Act has been filed with the Registrar of Companies within one month of the date of allotment and, in the absence thereof, a memorandum in writing stating particulars of the contract has been filed.

### 9.5 SHARES ISSUED AT A PREMIUM

Where a company has issued shares at a premium, whether for cash or otherwise, Section 78 of the Act prescribes that a sum equal to the amount of the premium collected should be transferred to the Share Premium Account. As per Section 78 of the Act the auditor must also ensure that the amount of premium is utilised only for the specific purposes such as (a) issuing fully-paid bonus shares, to members of the company; (b) writing off the preliminary expenses or the commission paid or discount allowed on any issue of shares or debentures of the company, or (c) providing for the premium payable on the redemption of any redeemable preference shares or any debentures of the company.

### 9.6 SHARES ISSUED AT A DISCOUNT

A company may issue shares at a discount as per the following conditions specified in section 79 of the Act:

- 1 The issue should be authorised by an ordinary resolution of the company and sanctioned by the Company Law Board.
- 2 The maximum rate of discount should not exceed 10% unless the Company Law Board is of opinion that a higher rate of discount may be allowed under the special circumstances of the case.
- 3 The shares must be issued within two months of the sanction by the Company Law Board but not earlier than one year after the date of commencement of business.
- 4 The shares should be of a class already issued by the company.

It is the duty of the auditor to confirm that all the aforementioned conditions had been complied with by the company at the time the allotment was made. Normally, it is advisable to write-off the amount of such discount over a period 5 to 10 years. The amount of discount, until written off, should be shown separately in the Balance Sheet under the head "Miscellaneous Expenditure not written off".

### 9.7 AUDIT OF CALLS

You have learnt about the audit procedure for calls stage under section 9.3.1. In this regard, the auditor should also examine compliance with the provisions of the Articles of Association, and inspect Director's Minute Book, to ensure that the resolution states the time and place of payment, and see that the calls were made on a uniform basis as regards all shares falling under the same class. Then he may proceed to audit the calls in arrears and calls in advance.

#### 9.7.1 Calls in Arrears

The sum of money still due from shareholders on account of calls made by the company is known as calls-in-arrears. Audit procedure in this regard is as under:

- 1 Verify calls-in-arrears from the share register.
- 2 Verify the interest adjustment in case the Articles provide for a charge of interest on calls-in-arrears.
- 3 See that the amount of calls in arrears is properly shown on the liabilities side of the Balance sheet by deducting it from the amount of called-up capital.

- 4 Ensure that the amount of calls due from directors should be separately shown in the Balance sheet.

**9.7.2 Calls in advance**

A company may, if so authorised by its Articles of Association, accept from any member the whole or a part of the amount uncalled on any shares held by him as calls-in-advance. However, the amount so received cannot be treated as part of the capital for purposes of any voting rights. But according to Section 93 of the Act, a company may, if so authorised by its Articles, pay dividend in proportion to the amount paid up on each share where a larger amount is paid up on some shares than on others.

Where the company does not exercise its right under Section 93, the shareholders who have paid calls in advance shall be entitled to receive interest at the rate prescribed in the Articles of Association. Such interest is chargeable against profits but in case profits are not available for the purpose, it can be paid out of capital. Similarly, in the case of winding up, repayment of calls in advance along with interest accrued thereon, will take precedence over return of capital. Audit procedure in respect of calls in advance can be summarised as under:

- 1 Check the amount of calls in advance with entries in the Share Register and the Cash Book.
- 2 Ensure that calls in advance are shown separately in the Balance Sheet, and not shown as part of capital.
- 3 See that the shareholders concerned are paid interest on calls in advance at the rate specified in the Articles provided the Articles do not permit payment of dividend in respect thereof.

**Check Your Progress A**

- 1 State whether the following statements are True or False.
  - i) In view of the utility of auditing, it is essential for every form of business organisation to get its accounts audited.
  - ii) If a company is passing through a financial crisis, it need not get its accounts audited for a few years.
  - iii) An audited balance sheet presents a true and fair view of the state of affairs of the company.
  - iv) Audit of a company is voluntary and informal
  - v) The statutory powers of a company auditor can be limited by an agreement between the auditors and directors of the company.
- 2 Name the three stages involved in issue of share capital for cash.
 

.....

.....

.....
- 3 State the purposes for which share premium can be utilised.
 

.....

.....

.....
- 4 List the conditions under which a company can issue shares at a discount
 

.....

.....

.....

5. Which of the following statements are correct?
  - i) In a fresh issue of share capital, the auditor must examine preliminary contracts.
  - ii) SEBI guidelines for issue of share capital have no impact on the audit procedures.
  - iii) Share can be issued against cash only
  - iv) Share premium can be utilised for writing off losses incurred by the company.
  - v) A company may issue shares at a discount within six months of sanction given by company law Board.

**9.8 FORFEITURE AND REISSUE OF SHARES**

You know that the question of forfeiture of shares arises in case some shareholders fail to pay the amount due on calls. The Board may exercise its power to forfeit share only in the best interests of the company. Audit procedure to be followed in this regard is as under:

- 1 Examine whether the Articles of Association permit the forfeiture of shares.
- 2 Ascertain compliance with the procedural requirements contained in the articles of association.
- 3 Examine Board's resolution relating to forfeiture.
- 4 Verify the amount of call or installment of calls which was outstanding respect of each of the share forfeited
- 5 Verify the entries recorded in the books of account consequent upon forfeiture of shares to confirm that the premium, if any, received on the issue of shares has not been transferred to the Shares Forfeited Account.

**Reissue of Forfeited Shares**

Reissue of forfeited shares is a logical consequence after forfeiture of shares. In case a company decides not to reissue the forfeited shares, such forfeited shares would be the property of the company and this would amount to reduction of share capital. The companies therefore, usually decide to reissue the forfeited shares. The reissue of forfeited shares can be made at any price provided that the total of the sum paid by the former shareholder together with the amount paid on reissue and the amount remaining unpaid on these shares is not less than the face value. The audit of reissue of such shares involve the following:

- 1 Ascertain that the Board of Directors has the authority under the Articles to re-issue forfeited shares.
- 2 Refer to the resolution of the Board of Directors, realoting the forfeited shares.
- 3 Examine whether forfeited share had been reissued for an amount not less than the amount which remained unpaid on those share.
- 4 Ensure that the amount originally paid-up in respect of forfeited shares has been added to the share capital in case of reissue of forfeited shares.
- 5 Verify that the capital profit if any, on reissue of forfeited shares has been duly transferred to capital reserve.

**9.9 ISSUE AND REDEMPTION OF PREFERENCE SHARES**

Audit procedure to be followed in respect of issue of preference share is as under:

- 1 Examine whether the Articles of Association authorise the company to issue redeemable preference shares.

- 2 Check compliance with relevant legal provisions of the Companies Act, 1956 e.g. Section 80(5A) prohibits any company to issue any preference share which are irredeemable or redeemable after the expiry of a period of 20 years from the date of the issue.
- 3 Check whether the terms of redemption or conversion are stated in the balance sheet together with the earliest date of redemption or conversion.
- 4 Vouch receipt of moneys on the issue of preference shares.

#### Redemption of Preference Shares

In case of preference shares redeemed during the year, the audit procedure is as under:

- 1 Examine whether the redemption is in accordance with the relevant requirements of the Companies Act, 1956 and the terms of issue.
- 2 Verify the payment made to preference shareholders on redemption with reference to bank statement and receipts issued by the shareholders.
- 3 Confirm that the requirements of Section 80 of the Act as stated below have been complied with
  - i) that the shares redeemed were fully paid up;
  - ii) that the shares were redeemed out of profit, otherwise available for distribution as dividend, or out of proceeds of a fresh issue made for purpose of redemption;
  - iii) that the premium, if any, on redemption was provided for either out of the Share Premium Account or out of divisible profits of the company; and
  - iv) that if the shares were redeemed out of profits, otherwise available for dividend, an amount equal to nominal amount of shares redeemed has been transferred to the Capital Redemption Reserve Account.

### 9.10 ISSUE OF BONUS SHARES

A company, subject to certain conditions, may decide to capitalise its undistributed profits or reserves by issue of fully paid-up bonus shares. Audit procedure in this regard is as under:

- 1 Ascertain whether the articles of association permit capitalisation of profits.
- 2 Inspect resolution passed by the board of directors and shareholders authorising the issue of bonus shares.
- 3 Confirm that all statutory requirements relevant to the issue of shares have been complied with.
- 4 Ensure that SEBI Guidelines in respect of listed companies relating to issue of bonus shares have been complied with.
- 5 Examine the sources from which bonus shares have been issued i.e. general reserves, capital redemption reserve, share premium account, etc. It may be noted that bonus shares cannot be issued out of revaluation reserve.

### 9.11 ALTERATION OF SHARE CAPITAL

Section 94 of the Act empowers a company having share capital to alter its share capital by passing an ordinary resolution without confirmation of the Court. Alteration of share capital may involve (i) increase of share capital by issuing new shares; (ii) consolidate and divide share capital into shares of larger amount; (iii) convert fully-paid up shares into stock or vice versa; (iv) sub-divide its shares into smaller amount or (v) cancel its share capital not called up. Whatever the form the audit procedure to be followed is as under:

- 1 Verify that the alteration of capital is authorised by the Articles.
- 2 Inspect the minutes of the shareholders meeting authorising the alteration.
- 3 Obtain allotment lists containing details of the new holdings of share or stock by each member and verify the same with the entries.
- 4 Inspect the directors' resolution with regard to allotment, consolidation, conversion or sub-division passed pursuant to the resolution of the members.
- 5 Examine the cancelled share certificates, if any, and tally the same with the counterfoils of new certificates issued;
- 6 See that the procedure, prescribed by the Articles in this regard, has been complied with;
- 7 Verify that the share capital account is correctly shown in the Balance Sheet;
- 8 Ensure that the necessary intimation has been sent to the Registrar of Companies.
- 9 Ensure that each alteration made should be noted in every copy of the Memorandum and Articles of Association issued subsequent to date of the alteration.

### 9.12 REDUCTION OF SHARE CAPITAL

Section 100 of the Act deals with the reduction of share capital and you know that it lays down quite a cumbersome procedure to be followed for the purpose. Its audit therefore has to be conducted very carefully which may involve the following .

- 1 Verify Shareholders' Minutes book that the necessary special resolution has been passed.
- 2 Confirm that the Articles of Association authorise reduction of share capital.
- 3 Examine the order of the Court confirming the reduction and ensure that copies of the court order and the relevant minutes have been filed with the Registrar of Companies.
- 4 Inspect the Registrar's Certificate in this regard
- 5 Vouch the journal entries recorded to reduce the capital and to write down the assets by reference to the resolution of shareholders and other documentary evidence, and also ensure that the requirements of Part I of Schedule VI, to the Act have been complied with.
- 6 Confirm that the reduction in value of assets has been properly disclosed in the Balance Sheet.
- 7 Verify the adjustment made in the members' accounts in the Register of Members and confirm that either the paid up amount shown on the old share certificates have been duly altered or new certificates have been issued after canceling the old, ones..
- 8 Confirm that the words "and reduced", if required by the order of the Court, have been added to the name of the company in the Balance Sheet.
- 9 Verify that the Memorandum of Association of the company has been suitably altered.

### 9.13 ISSUE OF SHARE CERTIFICATES

Every company, within three months after the allotment and within two months after the application for registration of the transfer, must have ready for delivery the certificates of all shares, debentures and the debenture stock, allotted or transferred. Audit procedure in this regard is as under:

- 1 Check share certificate certifying that the allottee is the holder of the specified number of shares in the company.

- 2 Verify entries in the Register of members with the counterfoils of the share certificates.
- 3 Ensure that all the books and documents concerning the issue of share certificates are properly maintained and preserved and certificates surrendered to the company are duly defaced by the word "cancelled".

**Issue of Share Warrants**

A public company limited by shares may convert its fully-paid up shares into share warrant if the following conditions are satisfied:

- a) the shares are fully paid up.
- b) the Articles authorise the issue of share warrants.
- c) prior approval of the Central Government has been obtained.
- d) the share warrants are issued under the common seal of the company.

A share warrant entitles the bearer to the shares specified therein, and it may be transferred merely by delivery of possession. The company may provide for payment of the future dividends on the share warrants, by attaching coupons for the dividend with the warrant itself. Dividend is then payable to the bearer of the coupon. Every share warrant, in fact, is a negotiable instrument.

Examine the Articles to ensure that the issue of share warrant is duly authorised therein.

**Check Your Progress B**

- 1 Preference shares can be redeemed only when following conditions are satisfied.  
.....  
.....  
.....
- 2 List the conditions under which a company may reduce its share capital.  
.....  
.....  
.....
- 3 Which of the following statements are True and False.
  - i) A company can issue irredeemable preference shares.
  - ii) Bonus share can be issued out of share premium.
  - iii) The issuing company has to specify the amount of minimum subscription in the prospectus for every public issue of shares.
  - iv) A company can issue bonus shares out of reserves created on revaluation of fixed assets.
  - v) Shares cannot be forfeited unless the article of association so provide.
  - vi) Profit on reissue of forfeited shares is required to be transferred to capital reserve.
  - vii) Capital redemption reserve is created on redemption of debentures.
  - viii) Capital redemption reserve can be utilised only for issuing fully paid-up bonus shares.
  - ix) A company can utilise share premium account for providing for premium payable on redemption of its debentures.

**9.14 SHARE TRANSFER AUDIT**

Normally, audit of transfer of share is beyond the scope of independent financial audit. But, it is quite common that an auditor may be given a specific assignment to audit the transfer of shares to ensure that such transfers are being carried out properly. The audit procedure to be followed is as under:

- 1 Ascertain and evaluate internal control system relating to share transfers with particular reference to segregation of duties, maintenance of records, etc.
- 2 Ascertain whether notices were sent in every case to the transferors and, in case of joint-holders, to each of the holders and the objections, if any, raised by them were taken into consideration before the transfers were registered.
- 3 Verify that in case of partly paid shares, where the application for registration was made by the transferor, a notice has been sent to the transferee and the transfer registered only if the transferee does not make any objection within two weeks from service of notice on him.
- 4 Scrutinise transfer deeds to ensure the following:
  - i) It is in the prescribed form.
  - ii) It bears stamp or other endorsement of the prescribed authority showing the date on which it was presented to such authority.
  - iii) It has been delivered to the company within the time-limits laid down in this behalf.
  - iv) It is accompanied by the related share certificates.
  - v) Any correction, erasure, overwriting, or crossing out, is properly authenticated.
  - vi) Number of shares to be transferred is correctly stated in figures and in words.
  - vii) Amount of consideration is correctly stated in figures and in words.
  - viii) Particulars such as folio no., name of the transferor etc. as stated in the transfer deed tally with those in the register of members.
  - ix) Transferor's signature on the transfer deed tally with his specimen signature as per the company's records.
  - x) If it is signed on behalf of a minor or lunatic, it is accompanied by a certified copy of the relevant court order for the sale of shares.
  - xi) If it is signed by an individual against whom insolvency proceedings are pending, it is duly certified and countersigned by the official assignee.
  - xii) If it is signed by or on behalf of a company against which the liquidation proceedings are pending, it is certified and counter-signed by the liquidator.
  - xiii) Transferor's signature are duly witnessed.
  - xiv) It contains the requisite particulars of the transferee.
  - xv) If it is duly signed by the transferee.
- 5 Verify by reference to the Minutes Book of the Board of Directors that all the transfers recorded in the Transfers Journal have been approved by the Board.
- 6 Check the postings of distinctive numbers of shares transferred and the name of transferors and transferees into the Register of Members from the Share Transfer Journal.
- 7 Verify the particulars entered on counterfoils of shares certificate issued to transferees in pursuance of the transfers registered by reference to Directors' Minute Book.
- 8 Verify that every duplicate Shares Certificate in lieu of the one lost or destroyed has been issued under the consent of the Board and on the conditions prescribed by the Board as regards production of evidence or execution of a Bond of Indemnity.



- 9 In cases where share certificates have been issued in replacement of old certificates, ascertain whether such a fact was entered on the face of the certificate and also whether such a fact was entered on the stub of the counterfoil.
- 10 Confirm that in the above mentioned two cases (8 & 9), the word "Duplicate" was punched or stamped in bold letters across the face of the share certificate.
- 11 Confirm that the forms of share certificates are printed only under the authority of the Board and that a person, appointed by the Board, is in custody of all the unused stock of Share Certificates, as well as, the blocks and other equipment employed for their printing and that the person appointed is responsible for rendering an account thereof.
- 12 Reconcile the amount of transfer fees collected with total number of transfers lodged and verify that the amounts of transfer fees have been accounted for.
- 13 Confirm that, in case where the registration of transfer had been refused, the notice of refusal was sent to the transferor and the transferee within a period of two months (Section 111).
- 14 Confirm that if a company has refused to register the transfer of, or the transmission by operation of law, the right to any shares within two months from the date on which the instrument of transfer or the intimation of such transmission was delivered to the company, a notice of the refusal has been sent to the transferee and the transferor or the person giving intimation of such transmission as the case may be, giving reasons for such refusal.

#### Transmission of Shares

Sometime shares are transferred to another person by operation of law on account of death or insolvency of a shareholder. The auditor should :

- i) ensure that the procedure prescribed by the Articles in this regard has been strictly followed.
- ii) confirm that the documents testifying the authority of the legal representative have been properly verified.
- iii) ascertain whether the order of the Court and other relevant documents have also been duly examined in the case of transmission of shares on insolvency.
- iv) examine the relevant minutes of the meetings of the Board of Directors.

### 9.15 PRESENTATION AND DISCLOSURE OF SHARE CAPITAL

As per the established audit procedure, the auditor is also required to verify whether share capital has been properly presented in the financial statements. Compliance with the requirements of the Part I of Schedule VI to the Act required to be seen by auditor is given below:

- 1 Authorised share capital should be shown separately stating the class of shares, the number of shares and the face value of each share.
- 2 Similarly, the number of shares issued and subscribed, and the face value of each share should be stated together with the amount called-up per share. While showing the issued and the subscribed capital, a distinction has to be made again between the various classes of capital i.e., ordinary share capital and preference share capital, and if there are different classes of preference shares, their particulars should also be given.
- 3 In the case of redeemable preference shares, the terms of redemption or conversion should also be stated, together with the earliest date of redemption or conversion.
- 4 In case the company under audit is a subsidiary of another company, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries should be separately stated in giving the particulars of the subscribed capital.

- 5 The number of shares allotted as fully paid-up pursuant to a contract, without payments being received in cash, and the number of shares allotted as fully paid-up bonus shares should also be stated. The source from which bonus shares are issued should also be specified.
- 6 If any calls are unpaid, the amount involved should be clearly stated, distinguishing between the calls unpaid by directors and those unpaid by others.
- 7 The amount originally paid-up on forfeited shares, not yet reissued, should be shown separately.
- 8 If there are any options on unlisted share capital, the particulars of the same should be given. For example, if the foreign collaborators of a company are entitled to subscribe to a specified percentage of any further issue of share capital, the same should be stated.
- 9 The amount of share capital included in the total of the balance sheet is the amount of share capital called-up, minus calls unpaid plus the amount originally paid-up on forfeited shares.

### 9.16 LET US SUM UP

The audit of a company differs from the audit of a partnership in various ways and involves many preliminaries. The auditor has to (a) make sure that his appointment is in order, (b) obtain a letter of engagement, and (c) acquaint himself with articles and memorandum of association, the scope of work, the system of accounting and internal control, etc. For the whole audit assignment he must follow the normal procedure of audit, the relevant statutory provisions and the guidelines of auditing standards.

Audit of share capital assumes significance at the time of incorporation of the company as well as subsequently when fresh share capital is issued.

Audit of share capital should be conducted at three stages viz, application stage, allotment stage and call stage. The auditor must ensure that in case of shares issued for cash, cash has actually been received. In case of shares issued for consideration other than cash the relevant contract may be examined. If the shares had been issued at a premium or at a discount, the auditor should examine compliance with all legal requirements and proper disclosure in the financial statements. The audit of calls on shares requires examination of calls-in-arrears and calls received in advance. In case some shareholders fail to pay money due on calls, companies may be forced to forfeit shares and reissue the same.

Redemption of preference shares can be made either out of fresh issue of shares or out of profits. An equivalent amount should be transferred to capital redemption reserve account in case these are redeemed out of distributable profits. If bonus shares have been issued, the auditor is required to check compliance with all statutory and other procedural requirements in this regard.

A company may alter its share capital in various ways. The auditor has to ensure that necessary procedure has been followed for the purpose and alterations are duly reflected in all the relevant documents and records.

Finally, audit of share transfers does not form part of normal audit work but companies get audited transfer of shares on a regular basis to ensure accuracy of the share transfers.

### 9.17 KEY WORDS

**Authorised Share Capital:** The number and par value, of each class of shares that an enterprise may issue in accordance with its instrument of incorporation. This is sometimes referred to as nominal share capital.

**Bonus Shares:** Shares allotted by capitalisation of the reserves or surplus of a corporate enterprise.

**Call:** A demand pursuant to terms of issue to pay a part or whole of the balance remaining payable on shares or debentures after allotment.

**Called-up Share Capital:** The part of the subscribed share capital which shareholders have been required to pay.

**Capital Redemption Reserve:** A reserve created for the redemption of preference shares out of its distributable profits.

**Forfeited Share:** A share to which title is lost by a member on account of non-payment of call money or default in fulfilling any engagement between members or expulsion of members where the articles specifically provide therefor.

**Issued Share Capital:** That portion of the authorised share capital which has actually been offered for subscription. This includes any bonus shares allotted by the corporate enterprise.

**Paid-up Share Capital:** That part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise.

**Preliminary Expenses:** Expenses relating to the formation of an enterprise. These include legal, accounting and share issue expenses incurred for formation of the enterprise.

**Reduction of Share Capital:** The extinguishment or reduction of shareholders' liability on in respect of the subscribed share capital.

**Share Capital:** Aggregate amount of money paid or credited as paid on the shares and/or stocks of a corporate enterprise.

**Share Issued for Consideration other than Cash:** The shares issued to vendors as consideration for the assets acquired from them.

**Subscribed Share Capital:** That portion of the issued share capital which has actually been subscribed and allotted. This includes any bonus shares allotted by the corporate enterprise.

**Unissued Share Capital:** That portion of the authorised share capital for which shares have not been offered for subscription.

## 9.18 ANSWERS TO CHECK YOUR PROGRESS

- A 1 (i) False (ii) False (iii) True (iv) True (v) False  
 5 (i) is correct
- B 3 (i) False (ii) True (iii) True (iv) False (v) True  
 (vi) True (vii) False (viii) True (ix) True

## 9.19 TERMINAL QUESTIONS

- 1 Distinguish between audit of a firm and the audit of a limited company.
- 2 Discuss the preliminaries before commencement of the audit of a company
- 3 State briefly the procedure for checking the share capital of a newly started company in the first year of its existence.
- 4 What are the duties of an auditor of a company in regard to:-
  - i) Issue of shares at a premium.
  - ii) Issue of shares at a discount
  - iii) Forfeiture of shares.

- 5 What is the procedure followed by a company while making an issue of bonus shares? What are the duties of an auditor in respect thereof?
- 6 What are the objects of Share Transfer Audit? Set out a programme for conducting Share Transfer Audit.
- 7 During the year under audit you find that the company has redeemed its redeemable preference share capital. How would you verify this?
- 8 How will you examine the following items while auditing the accounts of a limited company?
  - i) Redemption of preference Shares.
  - ii) Forfeiture of Shares.
- 9 State the procedures an auditor should follow to verify the issue of share capital for (a) cash and (b) considerations other than cash.

**Note:** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

## UNIT 10 COMPANY AUDIT-II

### Structure

- 10.0 Objectives
- 10.1 Meaning of Profit
- 10.2 Divisible Profits and Dividends
- 10.3 Provisions of the Companies Act, 1956 for Dividends
  - 10.3.1 Sources of Dividends
  - 10.3.2 Procedural/Legal Requirements
  - 10.3.3 Significant Legal Cases
- 10.4 Distribution of Capital Profit
- 10.5 Auditor's Duty Regarding Dividends
- 10.6 Provisions Relating to Depreciation
  - 10.6.1 Provisions of the Act
  - 10.6.2 Auditor's Duty
- 10.7 Audit of Reserves
- 10.8 Let Us Sum Up
- 10.9 Key Words
- 10.10 Answers to Check Your Progress
- 10.11 Terminal Questions

### 10.0 OBJECTIVES

After studying this unit, you should be able to:

- Explain the meaning of profit
- define divisible profits and dividends
- list different sources from which dividends can be declared
- describe the procedural/legal requirements regarding payments of dividends
- state auditor's duties regarding dividends
- describe the provisions of the act regarding depreciation and enumerate auditor's duties in this regard
- State auditor's duties in relation to reserves.

### 10.1 MEANING OF PROFIT

Different authorities have defined the term 'profit' in different ways. The economists ascertain profits by comparing the market values of its net assets at two accounting dates. They treat the increase or decrease in the net worth as the profit/loss for the intervening period. Accountants, on the other hand, view profit differently. According to them, profit can be computed as above provided business is going to be liquidated. In fact, business entity is regarded as going concern which is one of the fundamental accounting assumptions underlining the preparation of financial statements. Therefore, the accountant does not look at realisable value of assets as the basis for computing profit. Moreover, it is very difficult to measure objectively the market price of business assets especially the fixed assets. For an accountant, profit is the difference between the revenue and the expenses of an accounting period. In this context, the judgement in the case of Spanish Prospecting Co. Ltd. (1911) is noteworthy

"... if the total assets of the business at two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowances, of course, being made for any capital introduction into or taken out of the business in the meanwhile) represents, in strictness, the profits of the business during the period in question. The strict meaning of 'profit' is rarely observed in drawing up the accounts of firms and companies .... Certain assumptions have become so customary in drawing up

Balance Sheets and Profit and Loss Account that it may almost be said to require special circumstances to induce parties to depart therefrom. For instance, it is usual to exclude gains and losses arising from causes not directly connected with the business of the company .... The value assigned to trade building and plant is usually fixed according to arbitrary rule, by which they are originally taken at their actual cost and are assumed to have depreciated by a certain percentage each year, though it cannot be pretended that any such calculation necessarily gives their true value either in use or exchange .... It is better to underrate than to overrate the profits since it is impossible for you to see all the risks to which a business may be exposed in future .... But though there is a wide field for variation of practice in these estimation of profits, this liberty ceases at once when the rights of third parties intervene .... In the absence of certain stipulation to the contrary, 'profits', in cases where the rights of third parties come in, mean actual profits and they must be calculated as clearly as possible, in accordance with the definition to which I have referred".

You may also note from the above that accounting policies play a very significant role in determination of true profits. You must have noticed that there are different accounting policies in vogue which may be followed by different enterprises. For instances, depreciation on fixed assets may be charged on straight line method or written-down value method. Depending upon the accounting policy followed by an entity, the figure of profit would also vary. Similarly, inventories are valued at cost or net realisable whichever is lower. The cost may be adopted by different accountants based on LIFO, FIFO, or specific identification method, etc. Each entity may adopt different estimate for writing off deferred revenue expenditure. Provision for bad and doubtful debts would depend upon the judgement of the management of the enterprise. Thus there can be no single magical figure of profit which would be arrived at under all circumstances.

In any case, it is necessary that profits are determined according to the generally accepted accounting principles as also having regard to the legal norms wherever applicable. Any overstatement of profit would result in payment of dividend out of capital consequently leading to reduction of capital and as such would be *ultra vires* and void. The understatement of profit, on the other hand, affects the stakeholders interests and leads to creation of secret reserves which is prohibited under the Act.

### 10.2 DIVISIBLE PROFITS AND DIVIDENDS

You may note that the term "divisible profits" has not been defined anywhere in the Act. First of all it is necessary to ascertain correct profits by following generally accepted accounting principles. Then, it is not necessary that entire profits be distributed amongst owners of the enterprise and thus consumed. In fact a part of profits must be retained by the enterprise to finance its growth and diversification. In case of companies, the Act also imposes certain restrictions on the extent to which profits can be distributed amongst its members. Accordingly, the part of the profits of a company which can be legally distributed to its members is known as 'divisible profits', and that part of divisible profits which is actually distributed is known as 'dividend'. In practice, the generally accepted principles of accountancy, the relevant provisions of the Companies Act, 1956 and the various judicial pronouncements in different court cases are the guiding factors in determining divisible profits. Let us discuss these factors in the following paragraphs.

### 10.3 PROVISIONS OF THE COMPANIES ACT, 1956 FOR DIVIDENDS

Section 205 of the Act enumerates the sources from which dividends can be paid. It makes it compulsory for a company to provide for depreciation before declaring dividends. A company may also be asked to transfer some part of its profit to reserves if it intends to pay dividend exceeding certain limit. It also lays down the procedure for declaration and payment of dividends including the manner of dealing with any unpaid or unclaimed dividends. In this the context, it is equally important that leading judicial pronouncements on the issue are given due attention.

### 10.3.1 Sources of Dividends

According to Section 205(1) of the Act, dividend can be declared or paid by a company for any financial year only out of the following three sources

- 1 its profit for that year, arrived at after providing depreciation as per Section 205(2); or
- 2 its profits for any previous financial year or years, after providing depreciation as per the second provision to Section 205(1); or
- 3 money provided by the Central Government or a State Government for the payment of dividends in pursuance of a guarantee thereof.

Let us now discuss each source briefly alongwith conditions attached thereto:

#### Dividend out of Current Year Profits

A company has to comply with the following while paying dividends out of the profits of the current year:

- a) **Provision for depreciation:** The profit for year would be arrived at only after providing depreciation both for the current year and for any past years.
- b) **Set-off in case of past losses:** Where a company has incurred a loss in any previous year(s), it should be set off against its profits of the current year or of any previous year:
  - i) the amount of loss for the previous year(s), or
  - ii) the amount of depreciation provided for such previous year(s), which ever is lower.

For example: a company incurred losses for the year 1994-95 and 1995-96 as per the details given below:

Year	Amount of Loss after charging depreciation	Provision for depreciation
	Rs.	Rs.
1994-95	25,000	40,000
1995-96	55,000	45,000

During 1996-97, the company earned profit of Rs.1,25,000 and wished to declare dividends. In such a situation, the company shall have to set off Rs. 70,000 (Rs. 105,000 for the year 1994-95 and Rs. 45,000 for the year 1995-96) against the profits of current year. Therefore, the distributable amount in 1996-97 would be Rs. 55,000 (Rs. 1,25,000-Rs. 70,000).

- c) **Transfer of Profits to Reserves:** A company must retain adequate funds to finance its growth. Therefore, the law requires that a company must transfer prescribed amount out of its current profits to reserves in case it intends to declare or pay dividend exceeding 10% on its paid up capital. However, there shall be no bar on a company if it voluntarily transfers a higher percentage of its profit to the reserves in accordance with such rules as may be made by the Central Government in this behalf. As at present, the relevant rules are as follows

Rate of dividend proposed (as percentage of paid-up capital)	Amount to be transferred to the reserves
i) Exceeding 10% but not exceeding 12.5%	Not less than 2.5% of current profits
ii) Exceeding 12.5% but not exceeding 15%	Not less than 5% of current profits
iii) Exceeding 15% but not exceeding 20%	Not less than 7.5% of current profits
iv) Exceeding 20%	Not less than 10% of current profits

### Dividend out of Undistributed Profits of Past Years

A dividend may be declared by a company out of the undistributed profits of past years. In such a case also, the company has to provide for depreciation in case the same has not been provided earlier and set off losses of past years to the extent attributable to depreciation, in the same manner as in the case of a distribution out of current profits. Besides, the company has to also comply with the relevant rules viz., [Companies (Declaration of Dividend out of Reserves) Rules, 1975]. These rules allow a company to utilise its profits earned by it in past years and transferred to reserves, for paying dividends, subject to certain restrictions as below.

- a) The rate of dividend should not exceed the average rate of dividend for the immediately preceding five years. This is subject to a further condition that the rate of dividend should not exceed ten per cent of the paid-up capital of the company.
- b) The total amount to be drawn from the reserves should not exceed ten per cent of paid-up capital and free reserves of the company.
- c) The amount drawn from reserves should be utilised, in the first instance, to set off the losses incurred in the current year, if any. Only the amount remaining after such set off can be utilised for paying dividend.
- d) The balance of reserves after such withdrawal should not be less than fifteen per cent of the paid-up capital of the company.

For the purpose of the above requirements, the term 'reserves' does not include any reserves created on revaluation of fixed assets as well as any capital reserves. It is also important to note that the above conditions apply only where dividend is declared out of 'reserves'. Thus, a company can declare dividend out of the balance of profit for past years which has not been transferred to any reserve (i.e., balance shown in the balance sheet under the head 'Surplus') without complying with the above conditions.

#### Dividend out of Moneys Provided by the Central or a State Government.

The central government or a state government may, in some cases guarantee the payment of a certain rate of dividend to induce investors to make investment in companies where the returns are uncertain or where the gestation period is quite long. Where any money is provided by a government in pursuance of any such guarantee given by it, the money can be utilised for the payment of dividend.

### 10.3.2 Procedural/Legal Requirements

The procedure for declaration and payment of dividends is governed by Sections 205-207 of the Act and the provisions contained in the Articles of Association. Regulations 85-94 of Table A of Schedule I to the Act, deal with various aspects of dividends. It may be noted that a company can prescribe different rules. These rules can be summarised as follows:

- 1 **Authority for declaring dividend:** Regulation 85 of Table A provides that "the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board".
- 2 **Dividend payable in cash only:** According to Section 205(3), dividends is only payable in cash. However, there is no prohibition as to capitalisation of profits or reserves by means of issue of bonus shares or paying up any amount, which is for the time being unpaid, in respect of any shares held by members of the company.
- 3 **Time Limit for payment of dividend:** The dividends declared by a company are required to be paid within forty-two days of such declaration. For this purpose, it is sufficient if the cheque or warrant in respect of the dividend payable is posted within the prescribed period of forty-two days.
- 4 **Unpaid dividend to be transferred to a special dividend account:** Under Section 205A(a), the company has been given 410 days' time from the date of declaration of dividend within which it must pay dividend or post dividend warrants to all shareholders entitled to the payment of dividend. However, if the

company does not comply with this, it is required under Section 205A(1) to transfer the entire amount of unpaid dividend to a special account in any schedule bank to be called Unpaid Dividend Account of Company Ltd. or (Private) Ltd. Such transfer should be effected within 7 days of the expiry of the 410-day period.

- 5 **Transfer of Unpaid or Unclaimed Dividend to Central Government:** Section 205A(5) provides that where (i) any unpaid or unclaimed dividend has been transferred by a company to a special bank account, and (ii) any amount transferred to such account is not paid or claimed within a period of three years from the date of the transfer, the amount remaining unpaid or unclaimed should be transferred to the general revenue account of the central government. Upon such transfer, any person who claims to be entitled to any amount of dividend so transferred, has to make an application to the central government for payment.
- 6 **Dividends not to be paid except to registered shareholders, or to their order, or to their bankers:** Under Section 206 of the Act, dividend in respect of any share shall be paid by a company-(i) to a registered holder of such share, or to his order, or to his banker; or (ii) in the case of a share warrant issued in respect of the share in pursuance of Section 114, to the bearer of such warrant or to his bankers.
- 7 **Right to dividend, rights and bonus shares to be held in abeyance, pending registration (Section 206A):** According to the new Section 206A inserted by the Companies (Amendment) Act, 1988, if any instrument of transfer has been delivered to any company for registration, and the transfer of such shares has not been registered by the company, then the company will be required to (i) to transfer the dividend in respect of such shares to the Unpaid Dividend Account (Section 205A), and the amount of the dividend will not be paid to the transferee as specified in the instrument of transfer unless the registered holder of such shares authorises the company in writing to do so, and (ii) keep in abeyance any offer of rights shares Section 81(1)(A) or any issue of fully-paid bonus shares Section 205(3) in respect of such shares.
- 8 **Right to dividend:** The right of claiming dividend arises only after the declaration of dividend in the company's general meeting. It is only after this that dividend becomes a debt. Dividend once declared in this way cannot be revoked, unless it is done so with the consent of the shareholders.
- 9 **No dividend for past years:** Dividend cannot be declared for past years in respect of which the accounts have already been closed in a previous annual general meeting. It is also beyond the powers of the company to declare a further dividend after declaration of dividend at the annual general meeting.
- 10 **Prohibition on declaration of dividend in case of failure to redeem preference shares:** Section 205(10B) prohibits a company, which fails to comply with the requirements of Section 80 A relating to redemption of any preference shares issued by it, from declaring any dividend on its equity shares so long as the failure continues.

### 10.3.3 Significant Legal Cases

**Lee v. Neuchatel Asphalte Co. Ltd. (1889):** The suit was filed by a shareholder seeking to restrain the directors of the company from distribution of dividend to the preference shareholders without providing for depreciation of the company's property. The Articles of the company specifically stated that the directors were not bound to set apart funds for renewal or replacement of any lease of mine, or for any other property or concession of the company. However, the directors were from time to time providing large amounts for writing off assets, though in the year to which the case related, they had not made any such provision. It was held in this case was "a company, empowered to do so by its Articles of Association may distribute dividends without making good the depreciation of wasting assets". From the auditor's point of view, an important point made in the judgement is as follows:

"If a company is formed to acquire or work any property of a wasting nature, e.g., a mine, quarry or patent, the capital expend in acquiring the property may be regarded as a sunk and gone, and any excess of money obtained by working the mine over the cost

of working it, may be divided among the shareholders; and this is true, although some portion of the property itself is sold and, in one sense, the capital is thereby diminished".

**Verner v. General and Commercial Investments Trust Ltd. (1894):** The company had made substantial investment of its capital and proceeds of the issue of debentures in securities of other concerns. The investments fell steeply, without any foreseeable prospect of early recovery. In the year to which the case related, the company proposed to pay a dividend without providing for the loss in the value of its investments. The company was allowed to do so. It was decided that a company may pay dividends if it is solvent and is acting within its Articles even though the capital of the company is not intact.

**Wilmer v. McNamara & Co. Ltd. (1895):** The company proposed to pay dividend to its preference shareholders without providing for depreciation in respect of plant, goodwill, leases, etc., though in earlier years it had duly done so. An ordinary shareholder moved the Court to stop the company from giving effect to this. However, the court refused to intervene, applying the principle laid down in Lee v. Neuchatel Asphalte Co. it was decided that a company cannot be restrained declaring a dividend out of current profits for the reason that no provision has been made for depreciation of fixed assets.

**Crabtree, Thomas v. Crabtree (1910):** A trust was created for the benefit of the testator's wife. The trustees had, before ascertaining the profits of the business under trust, provided depreciation on the machinery employed therein. The beneficiary brought an action praying for disallowance of depreciation. The Court dismissed the case, holding that depreciation had been properly provided. The judgement held that normal charges in respect of depreciation of fixed assets ought properly to be made prior to the ascertainment of profits for distribution.

**Ammonia Soda Co. v. Arthur Chamberlain (1918):** The Profit and Loss Account of the company showed a loss owing mainly to the debits on account of depreciation, plant and machinery, mortgage and debenture interest, and directors' fees. Upon a boring made by the company to reach water, a hitherto unknown bed of rocksalt was discovered which, in the directors' opinion, was a reasonable enough ground to write up the value of company's property. The appreciation made in the value of land was used to write off losses disclosed by the Profit and Loss Account and in a subsequent year, a dividend was declared on preference shares out of the profits made. A suit was brought against the directors to make them liable for paying dividend out of capital. The Court rejected the plea holding that revaluation of property was bonafide and no material information had been held back from the shareholders.

Held that, a company may write up its assets as a result of a bonafide revaluation, and may divide current profits without first writing off prior losses. There is no rule of law which forbids a company from setting off an appreciation in the value of its capital assets, as ascertained by a bonafide valuation against losses on revenue; and the dividend in this case was not in fact paid out of capital, but out of current profits.

### Check Your Progress A

- 1 Define divisible profits.  
.....  
.....  
.....
- 2 List sources of dividends.  
.....  
.....  
.....
- 3 State whether the following statements are True or False.  
i) Dividend for a year can be paid only out of profits of that year.

- ii) In determining the amount of profits for a year out of which dividend can be paid, it is necessary to provide depreciation on fixed assets
- iii) Before declaring dividend, it is necessary for a company to set off the entire amount of loss incurred by it in previous years.
- iv) A company is required to transfer a certain percentage of its profits to reserves before declaring dividend, irrespective of the rate of dividend.
- v) There is some restriction on the amount of dividends which can be declared out of reserves.

## 10.4 DISTRIBUTION OF CAPITAL PROFIT

Profits earned during normal course of the business can be distributed as dividends under Section 205 of the Act. Some profits do not arise in the normal course of business. Capital profits fall in that category. The capital profits arise on account of profits made on the sale of fixed assets/long term investments or on account of their revaluation. The question arises whether such profits can be distributed as dividends or not. The Act, however, has not specifically dealt with the issue. In this context, decisions in the following two leading cases may help in formulating some general conclusions.

**Lubbock v. the British Bank of South America Ltd (1891):** In January 1891, the British Bank of South America sold its branches in Brazil and repurchased them sometimes later at a profit of \$2,05,000. The directors wanted to credit the Profit and Loss Account with this sum and to pay dividend to the shareholders. A shareholder brought about this friendly action to test and ensure the legality of this action of the directors. The action was brought just to elicit the opinion of the Court because the Articles of Association of the British Bank were silent on the point with regard to the calculation of divisible profits.

The court gave its opinion in favour of the directors and held that the dividends can be paid out of realised capital profits provided that:

- 1 the Articles of the company permit; and
- 2 a surplus is left after deducting the paid up capital and liabilities out of the sale proceeds, representing profit.

**Foster v. The New Trinidad Lake Asphalt Co. Ltd. (1901):** Company was formed to take over the assets of another business. The assets so taken over included promissory notes which, at that time, were estimated to be valueless. However, after a few years, it realised those promissory notes in full and credited the amount to Profit and Loss Account. The company proposed to use these profits for the payment of dividend. A shareholder brought about an action to restrain the company from using these profits as capital profits since they had arisen by realisation of those Promissory Notes which had been taken over by the company at the time of its formation and then considered valueless.

It was held that these capital profits cannot be distributed as dividend without having regard to the results shown by the accounts of the company as a whole. This would, therefore, require the revaluation of all the assets and liabilities of the company. Byrne J, in the course of his judgement restraining the distribution of dividends observed:

"If I rightly appreciate the true effect of the decisions, the question of what profits is available for dividend depends upon the result of the whole account — fairly taken for the year, capital as well as profit and loss, and although dividends may be paid out of earned profits, in proper cases. Although there has been a depreciation of capital, I do not think that a realised accretion to the estimated value of one item of the capital assets can be deemed to be profit divisible amongst the shareholders, without reference to the result of the whole account fairly taken".

On the basis of the above court decisions we come to the conclusion that the capital profits may be distributed as dividends provided the following conditions are satisfied:

- 1 The Articles of Association should permit distribution of capital profits as dividend.
- 2 Such profit which is sought to be distributed should have actually been realised. Unrealised capital profits, e.g., those arising on a revaluation of fixed assets, cannot be distributed as dividends. However, if the assets so revalued are subsequently sold, the amount realised over and above the original cost of such assets is a capital profit available for distribution as dividend, provided the other conditions are satisfied.
- 3 The capital profit should remain after a proper valuation has been fairly taken of the whole of the assets and liabilities. In other words, any fall or deficiency in the value of other assets or appreciation in the amount of liabilities should be deducted from the amount of capital profits to ascertain the amount which can properly be regarded as distributable as dividend.

It should be noted that capital receipts such as premium on shares and profits on reissue of forfeited shares cannot be distributed as dividends.

## 10.5 AUDITOR'S DUTY REGARDING DIVIDENDS

The auditor has to ensure that relevant provisions and procedure of the Companies Act, 1956 has been complied with regarding declaration and payment of dividends. The audit procedure to be involved the following:

- 1 Examine the Memorandum and Articles of Association of the company to ascertain the dividend rights of the various classes of shares.
- 2 Verify the rate of dividend and the authority for payment from the Shareholders' Minute Book.
- 3 Examine whether the procedural requirements relating to declaration of dividends had been complied with. The auditor examines the minutes of the board meeting at which the resolution recommending the declaration of dividends have been passed. He also examines the minutes of the general meeting at which the dividends have been declared.
- 4 Examine whether the dividends declared by the company had been paid within the prescribed time limit. For this purpose, the auditor examines the dividend registers showing the date(s) of despatch of cheques or dividend warrants.
- 5 Vouch the payment of dividends from the entries made in the Dividend Account, Profit and Loss Account, the Cash Book and the shareholders receipts. He will see that unclaimed dividend is shown in the Balance Sheet as a current liability and has been either deposited with a Scheduled Bank or the Government of India Account with the Reserve Bank, as the case may be.
- 6 Check the amount of gross dividends payable with reference to the paid-up share capital. Reconcile the net dividends payable with the gross dividends payable and the income-tax deducted at source. Check the gross and net dividends payable to individual members on a sampling basis.
- 7 Examine statement of unclaimed dividends with reference to the bank statement. Verify whether the company has complied with the requirements of the Act in this regard.

## 10.6 PROVISIONS RELATING TO DEPRECIATION

You know that it is essential to provide for depreciation to ascertain a true and fair view of the financial position of the enterprise. You have also learnt that in case of declaration of dividends, the Act requires that a company must provide for depreciation for the current year as well as for the past years for which no depreciation has been provided in the prescribed manner to compute the amount of divisible profits. It was laid in *Lee v. Neuchatel Asphalt Co. Ltd, (1889)* and *Wilmer v. Mc.Namara and Co.*

Ltd, (1895), that depreciation being an essential charge against profits must be provided for any before declaration of dividends.

**10.6.1 Provisions of the Act**

The relevant provisions of the Act in this regard which an auditor must observe are discussed in the following paragraphs.

According to Section 205(10), depreciation shall be provided either

- a) to the extent specified in Section 350; or
- b) in respect of each item of depreciable asset, for such an amount as is arrived at by dividing 95% of the original cost thereof to the company, by the specified period in respect of such asset; or
- c) on any other basis approved by the Central Government which has the effect of writing off by way of depreciation, 95% of the original cost to the company of each such depreciable asset on the expiry of the specified period; or
- d) as regards any other depreciable asset, for which no rate of depreciation has been laid down in Schedule XIV of the Act or by the Rules made thereunder, or such basis as may be approved by the Central Government by any general or particular order.

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), then, in the event of the depreciable asset being sold, discarded, demolished or destroyed, the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the proviso to Section 350.

Under Section 205(1)(c), the Central, Government may, if it thinks necessary to do so in public interest, exempt any company from the requirement of providing depreciation before declaring or paying dividend for that year.

Thus, it is clear that a company may follow written down value method or straight line method, using the rates of depreciation specified in Schedule XIV to the Act. It may be noted that rates specified in Schedule XIV are the minimum rates and in case the management is of the opinion that the useful life of asset is likely to be shorter, it may provide depreciation at higher rates. In case of assets for which a rate has not been provided in Schedule XIV, depreciation should be provided on a basis approved by the Central Government by any general order or by a special order in a particular case. You may also note that as per Schedule XIV depreciation on fixed assets whose actual cost does not exceed Rs. 5000 should be provided at 100%.

Apart from the written down value methods or the straight line method, depreciation can also be provided on any other basis provided (a) the basis has the approval of the central government, and (b) by providing depreciation on such basis, 95 percent of the original cost of the asset should be written off on the expiry of the specified period.

**10.6.2 Auditor's Duty**

The auditor has to ensure that the depreciation provided as per the established accounting principles is adequate and reasonable, by whatever approved method or rate it may be calculated.. The other duties of an auditor in this regard are as under:

- 1 Examine that depreciation has been provided properly and is adequate since a lower charge of depreciation would distort true and fair view of financial statements and a higher charge would lead to creation of secret reserves
- 2 Ensure that depreciation is provided on a consistent basis. The effect of change in method should be quantified and disclosed.
- 3 See that when a change in method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus of depreciation arising from the change in method should be taken to the profit and loss account.

- 4 Examine that the depreciation is provided on the revalued amount where an asset has been revalued. The effect of revaluation on the amount of depreciation should be disclosed separately in the year in which revaluation is carried out.
- 5 Ensure that net surplus or deficiency arising out of disposal/sale/discarded/ destruction etc. of asset is disclosed separately.
- 6 See that the following disclosures have been made in the financial statements:
  - a) Total depreciation for the period for each class of assets, as well as the related accumulated depreciation.
  - b) Accounting policy relating to depreciation, i.e.
    - i) the depreciation methods, followed and
    - ii) the depreciation rates used or the useful lives of the assets, if they are different from the rates prescribed by the statute governing the enterprise.

**Check Your Progress B**

- 1 State the conditions to be satisfied for distribution of capital profits as dividends.
 

.....

.....

.....
- 2 Distinguish between Capital profit and Capital receipt.
 

.....

.....

.....
- 3 State whether the following statements are True or false.
  - i) Profits on sale of fixed assets can never be distributed as dividends.
  - ii) A company can follow only the straight line method or the written down value method for providing depreciation for the purposes of provisions relating to dividends.
  - iii) If no rate of depreciation for a particular fixed asset is prescribed in Schedule XIV to the Companies Act, 1956, depreciation is not required to be provided in respect thereof.
  - iv) The rates of depreciation laid down in Schedule XIV to the Companies Act, 1956 are the minimum rates of depreciation. A company can provide depreciation at higher rates in appropriate cases.
  - v) The dividend declared by the shareholders of a company in general meeting can be higher or lower than the rate recommended by the board of directors.
  - vi) A company cannot declare dividend out of share premium account.

**10.7 AUDIT OF RESERVES**

You know that a company normally does not distribute the whole amount of profits earned in any accounting year and it is always considered prudent to retain some amount of profit in the form of reserves for meeting the growing capital needs of the company and its future exigencies. You learnt about the and various types of reserves created out of profits by a company in your first course on accounting viz., ECO-02 Accountancy-I. Here, we shall deal with the audit of reserves which acquires special significance since some reserves may not available for distribution of dividends.

The duties of an auditor regarding reserves are as under:

- 1 Check the opening balance of reserves with the previous years audited balance sheet.
- 2 Ascertain movement in reserves during the year and refer to Board's Resolution, etc.
- 3 Ensure that reserves do not contain an element of provisions.
- 4 Examine special reserves with reference to the relevant legal or contractual provisions i.e., whether the creation as well as the utilisation of such reserves is in accordance with the relevant legal or contractual provisions. For example, the Income-tax Act, earlier required the creation of an Investment Allowance Reserve under certain circumstances. The auditor has to ensure strict conformity to rules of the Act in this behalf.
- 5 Examine other reserves like general reserve or dividend equalisation reserve etc., with reference to the figures in the audited balance sheet for the previous year and the additions/withdrawals made during the year.
- 6 Examine that if there is a surplus in the profit and loss account after providing for proposed allocations to reserves and dividends, it is disclosed separately.
- 7 Ensure that no secret reserve has been created either by making excess provision, or under-valuation of assets, or mis-classification of expenditure, between capital and revenue etc.

#### Capital Reserves

- i) Ensure that capital reserve does not include any amounts regarded as free for distribution as dividends. Accordingly, it is shown separately in the Balance Sheet and not mixed up with any other reserve or general reserve.
- ii) See that it is created out of capital profits only. You may note that in the case of a company, capital profit, if any, on reissue of forfeited share is shown under capital reserves.
- iii) Check that relevant provisions of the Act, Articles of Association etc. have been complied in case of its utilisation

#### Capital Redemption Reserve

- i) Examine whether the capital redemption reserve has been created in accordance with the provisions of Section 80 of the Companies Act, 1956, and disclosed separately in the balance sheet. A sum equal to the nominal amount of the preference shares so redeemed has to be transferred from its distributable profits to a special reserve, called the capital redemption reserve account, except to the extent that a fresh issue of share capital has been made.
- ii) Examine whether it has been utilised in accordance with Section 80 i.e. only for issuing fully paid-up bonus shares. Compliance with the requirements relating to bonus shares should also be examined.

#### Share Premium

- i) Examine whether the premium is credited to the share premium account which is disclosed separately in the balance sheet.
- ii) Check compliance with provision of Section 78 in respect of its utilization as under:
  - a) for issuing fully paid-up bonus shares to the members of the company;
  - b) for writing off the preliminary expenses of the company;
  - c) for writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or
  - d) for providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.
- iii) Ensure that details of utilisation of share premium account during the year, are disclosed in the balance sheet.

#### Revaluation Reserve

- i) See that an increase in the book value of fixed assets consequent to a revaluation should be credited to revaluation reserve. It may be noted that revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, a company cannot issue bonus shares out of revaluation reserve.
- ii) Ensure that accumulated losses and arrears of depreciation should not be adjusted against revaluation reserve.
- iii) Ensure that depreciation on revalued assets is charged on the basis of the revalued figures. However, there is no legal bar if a company transfers an amount equal to the additional depreciation (i.e., depreciation attributable to increase in the book value of the fixed assets consequent to revaluation) from the revaluation reserve to the profit and loss account. However, in such a case, appropriate disclosures should be made in the financial statements.

#### Sinking Fund

- i) Examine the terms and condition with reference to each sinking fund and see that the same are complied with. For example, in the case of creation of Debentures Redemption Fund under a trust deed, the auditor should see that all its requirements are being met.
- ii) Ensure that sums are invested in earmarked securities.
- iii) See that the sums set aside for the redemption of liabilities, or for acquisition of a new asset, are adequate and, for this purpose, auditor should go through the calculations of the amount to be invested and the rate of yield.
- iv) See that any profit or loss on realisation or redemption of liability or acquisition of a new asset is carried to the Sinking Fund Account and not to the Profit and Loss Account.

## 10.8 LET US SUM UP

It is necessary that profits are determined on the basis of generally accepted accounting principles as also the legal norms wherever applicable. The amount of profit that can be legally distributed as dividends is termed divisible profits Section 205 of the Companies Act, 1956 lays down necessary provision regarding payment of dividends.

Dividends can either be distributed out of current profits or out of past profits or in certain cases out of moneys provided by the Central or State Government. A company must provide for depreciation before declaring any dividend. As per the principles laid down in leading judgements capital profits can be distributed as dividends provided: (i) there exists an authority of the Articles of Association. (ii) there have actually been realised in cash, and (iii) revaluation of all assets and liabilities to write off all capital losses. The law is also requires that dividends be paid in cash within stipulated time limits.

Audit procedure to be followed by auditor to vouch dividends would include compliance with statutory requirements regarding computation of divisible profits, examination of General Meeting Minutes' Book, Register of Members, etc. He must ensure that depreciation has been provided strictly in conformity with the provision of the Act in terms of the method followed and the amount provided. He has also to ensure that necessary amount is duly transferred to reserves if dividends exceed the prescribed limit.

## 10.9 KEY WORDS

**Capital Profit:** Profit earned on the sale of fixed assets or long term investments.

**Capital Redemption Reserve:** A reserve created on redemption of the redeemable preference shares of a corporate enterprise out of its profits which would otherwise have been available for distribution as dividend.



**Capital Reserve:** A reserve of a corporate enterprise which is not available for distribution as dividend.

**Cash Profit:** The net profit as increased by non-cash costs, such as depreciation, amortisation, etc.

**Dividend:** A distribution to shareholders out of company's profits or reserves available for this purpose.

**Divisible Profits:** That part of profits which can be legally distributed as dividend.

**Free Reserve:** A reserve the utilisation of which is not restricted in any manner.

**Sinking Fund:** Fund created out of profits for redemption of debentures or replacement of a fixed asset.

**Unclaimed Dividend:** Dividend which has been declared by a corporate enterprise and a warrant or a cheque in respect whereof has been despatched but has not been encashed by the shareholder concerned.

### 10.10 ANSWER TO CHECK YOUR PROGRESS

- A 3 (i) False (ii) True (iii) False (iv) False (v) True  
 B 3 (i) False (ii) False (iii) False (iv) True (v) False  
 (vi) True

### 10.11 TERMINAL QUESTIONS

- 1 What do you understand by 'Divisible Profits'? How are such profits determined?
- 2 What is the duty of a company auditor in relation to its divisible profits?
- 3 (a) Can a company declare dividend in a year without providing depreciation for the fixed assets and loss for the year? Discuss.  
 (b) Can a company pay dividend out of profits prior to incorporation? Explain.  
 (c) What are the circumstances under which dividend can be declared out of the profits previous years?
- 4 Can dividends be paid out of Capital Profits? If so, what are the legal limitations to such distribution?
- 5 When can the dividends be paid by a company out of the past accumulated profits or reserves?
- 6 A company may distribute dividend without making good the depreciation on its fixed assets. Comment giving legal decisions.
- 7 What are the provision with regard to unclaimed dividends? What are the duties of an auditor's in this regard?
- 8 State the legal requirements regarding provision for depreciation before declaring or paying dividend. State the duties of an auditor in relation thereto.
- 9 Enumerate the duties of an auditor with regard to audit of reserves.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

### SOME USEFUL BOOKS

Porwal & Kapoor, *Auditing, Theory and Practice*; Kitab Mahal, Allahabad, (Chapters 11-15)

Dinkar Pagare, *Principles and Practice of Auditing*. Sultan Chand & Sons, New Delhi, (Chapters 14, 15, 18-21)

Sharma Dr. T.R., *Auditing*. Sahitya Bhawan; Agra, (Chapters 9, 10 & 12)

Kamal Gupta and Ashok Arora, *Fundamentals of Auditing*. Tata McGraw-Hill Publishing Co. Ltd., New Delhi (Chapters 17 & 20).

---

## UNIT 11 AUDITOR'S REPORT

---

### Structure

- 11.0 Objectives
- 11.1 Introduction
- 11.2 Definition
- 11.3 Need and Importance
- 11.4 Reporting Responsibility
- 11.5 Report vs. Certificate
- 11.6 Qualities of a Good Report
- 11.7 Forms and Contents
- 11.8 MAOCARO
  - 11.8.1 Applicability
  - 11.8.2 Matters to be Included
- 11.9 Relevance of 'In Our Opinion'
- 11.10 True and Fair Concept
- 11.11 Clean Report and Qualified Report
- 11.12 Some Guiding Decisions
- 11.13 Let Us Sum Up
- 11.14 Key Words
- 11.15 Answers to Check Your Progress
- 11.16 Terminal Questions

---

### 11.0 OBJECTIVES

---

After studying this unit, you should be able to :

- explain the nature and utility of auditor's report
- explain its relevance and the purpose for which it is prepared and submitted
- distinguish between a report and a certificate
- describe the qualities of a good audit report
- enumerate the major contents of such reports in the context of relevant statutory provisions
- explain the scope nature and scope of MAOCARO
- explain the significance of true and fair concept
- differentiate between a clean audit report and a qualified audit report.

---

### 11.1 INTRODUCTION

---

The process of accounting is considered incomplete without an independent verification and examination of the books of account and the financial statements. The responsibility for such verification and examination lies with the auditors who conduct such audit and submit their report. Thus, an audit assignment begins with the appointment of auditors and concludes when the auditors submit their report to the company. In this unit you will learn about the nature and importance of such report, its content and form, the reporting responsibility and the guidance decisions in this regard.

---

### 11.2 DEFINITION

---

Auditor's Report is the means by which the auditors formally communicate the scope and the results of their audit to the members of the company as well as to the readers of the financial statements on which they are reporting.

Appointment of auditors in accordance with the provisions of the Companies Act assigns them a statutory duty and a professional responsibility of submitting their report. The Act requires the auditors to submit their report on the accounts examined by them containing their opinion on specified matters. Examination of books of account as a process of verification is the major duty required to be performed by the auditors. For this purpose, the auditors are considered to be the agents of the shareholders for whom their report is primarily meant. It is their duty to convey adequate information in respect of the financial position of the company to its shareholders through their report.

### 11.3 NEED AND IMPORTANCE

The relevance of auditor's report is governed by the following major provisions of the Companies Act:

- 1 that at every annual general meeting of a company, the Board of Directors of the company shall lay before the company:
  - (a) a **Balance Sheet** as at the end of the period; and
  - (b) a **Profit and Loss Account** for that period (Section 210)
- 2 that every Balance Sheet of a company shall give a **true and fair view** of the state of affairs of a company as at the end of the financial year and every Profit and Loss Account shall give a true and fair view of the profit or loss of the company for the financial year. (Section 211)
- 3 that the Profit and Loss Account shall be annexed to the Balance Sheet and the **auditor's report** shall be attached thereto. (Section 216)

The members of a company do extend their trust, faith and confidence to the report submitted by the auditors who are appointed to check the correctness and the fairness of the financial statements. In fact, the report offers an opportunity to the auditors to explain to the entire body of shareholders what they consider significant and relevant information relating to the financial position of the company for the period under reporting. It thus serves the following purposes.

- 1 It substantiates that the contents of the financial statements of the company represent a true state of affairs of the business.
- 2 Besides being an instrument of information to the shareholders of the company, it equally offers an opportunity to bankers, creditors, financial institutions and potential investors of the market to get reliable insight into the financial position of the company as demonstrated by its profit/loss and assets/liabilities.
- 3 Duly supported by professional expertise, statutory powers and performance independence, an auditor's report is an indicator of fairness of opinion and credibility of financial statements.

### 11.4 REPORTING RESPONSIBILITY

The main duties and responsibilities of the auditors in respect of the report are:

- 1 To protect and safeguard the rights of the shareholders against the misuse of directors' powers in managing the assets of the company;
- 2 To conduct sufficient examination of accounts so as to ensure that the transactions are legal and regular, with a view to informing the shareholders about the true financial position of the company; and
- 3 To disclose in their report any such activity of the management which may jeopardise the interest of the shareholders of the company who have contributed its capital.

In course of reporting, how the auditors arrive at their opinion or belief, and how they carry on their duties, depends on their technical competence and professional integrity and independence. The accounts have to be presented in accordance with the best

principles of the accountancy profession. The auditors, therefore, should bring to the notice of directors and shareholders alike any deviations from those principles.

### 11.5 REPORT VS. CERTIFICATE

An auditor's report is not a certificate of accuracy of accounts or financial statements. It would be necessary, therefore, to maintain a clear distinction between a report and a certificate. This difference can be placed in the following manner:

REPORT	CERTIFICATE
1 It is an expression of opinion on the financial statements of a company.	1 It vouchsafes the truth of the statement.
2 It is based on an examination of relevant records. Audit is only is only a test, and not a guarantee.	2 It is a guarantee of absolute correctness and accuracy.
3 It states that the Profit and Loss Account and the Balance Sheet represent a true and fair view of the state of affairs of the business.	3 Signing of a wrong certificate implies corresponding liability.
4 The auditors can not be held responsible for accuracy, because their report is simply an opinion on the working results of the company.	4 Auditors are not required to certify the accounts.

#### Check Your Progress A

- 1 What is an audit report?  
 .....  
 .....  
 .....  
 .....
- 2 In the process of discharging their reporting responsibilities, the auditors are free:
  - i) to act as advisers on company's policy
  - ii) to guarantee that the books of the company show the true position of its affairs and that its Balance Sheet is accurate according to the books.
  - iii) to be regarded as agents of the members who have appointed them to carry out certain duties.
  - iv) to act as a critic of management decisions
  - v) to be treated as watch-dogs and not bloodhounds
 State which of the above statements is True or False.
- 3 State any two points of difference between a report and a certificate.  
 .....  
 .....  
 .....

## 11.6. QUALITIES OF A GOOD REPORT

A good report from the auditors should normally have the following qualities:

- 1 Factual information
- 2 Effective presentation
- 3 Independent and unbiased approach
- 4 Honest identification of weaknesses in control
- 5 Positive outlook, balanced criticism and logical suggestions
- 6 Precise, brief and relevant

In other words, an auditor's report should contain an honest expression of opinion. It must be based on disinterestedness both in the formulation and expression of opinion. It should be guided by an independent and unbiased judgement. An objective consideration of facts should form as the basis of audit opinion. It should be free from any financial interest in the company or in its management. The report must be unambiguous and complete. Notes, if any, must accompany the report. Auditors are normally not expected to interfere into the justification of management policies or operation. They need not comment on unfair business practices of the company under audit. The report should demonstrate an impartial attitude. The reporting concern of the auditors should not remain confined to the management or to those who have an instant interest in the business of the company. It should also cover the interest of prospective or potential shareholders and creditors.

## 11.7 FORMS AND CONTENTS

Section 227 of the Companies Act, 1956 (as amended from time to time) defines the powers and duties of auditors. Clause (2) of this section states as follows:

"The auditor shall make a report to the members of the company on the accounts examined by him, and on every Balance Sheet and Profit and Loss Account and on every other document declared by this Act to be part of or annexed to the Balance Sheet or Profit and Loss Account, which are laid before the company in general meeting during his tenure of office, and the report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in the manner so required and give a true and fair view -

- (i) in the case of the Balance Sheet, of the state of the company's affairs as at the end of its financial year; and
- (ii) in the case of the Profit and Loss Account, of the profit or loss for its financial year.

Clause (3) of Section 227 provides that the auditor's report shall also state -

- (a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;
- (b) whether, in his opinion, proper books of accounts 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. Whether the report on the accounts of any branch office audited under Section 220 by a person other than the company's auditor has been forwarded to him; and
- (c) Whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

Before the financial statements of a company are circulated to the members of a company and others, auditors' and directors' reports must be attached to the financial statements of the company.

In view of the above, an auditor's report will usually take the form as per the report relating to ICICI Ltd. as follows:

## AUDITOR'S REPORT

To the members of:

The Industrial Credit and Investment Corporation of India Limited we have audited the attached Balance Sheet of THE INDUSTRIAL CREDIT AND INVESTMENT CORPORATIONS OF INDIA LIMITED as at March 31, 1997 and the annexed Revenue Account for the year ended on that date and report that:

- 1 As required by the Manufacturing and Other Companies (Auditor's Report) Order, 1988 issued by the Company Law Board in terms of Section (4A) of the Companies Act, 1956, we enclose in the Annexure a statement on the matters specified in paragraphs 4 and 5 of the said Order to the extent applicable to the Corporation
- 2 Further to our comments in the Annexure referred to in paragraph (1) above:
  - (a) we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purpose of our audit;
  - (b) in our opinion, proper books of account as required by law have been kept by the Corporation so far as appears from our examination of the books;
  - (c) the report of the Branch Auditors in respect of the two Zonal Offices audited by them under Section 228 of the Companies Act, 1956 has been forwarded to us and has been duly considered by us in preparing our Report;
  - (d) the Balance Sheet and Revenue Account dealt with by this report are in agreement with the books of account of the Corporation;
  - (e) in our opinion and to the best of our information and according to the explanations given to us, the said accounts read with the notes thereon, give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view:
    - i) in the case of the Balance Sheet, of the state of affairs of the Corporation as at March 31, 1997; and
    - ii) in the case of the Revenue Account, of the profit for the year ended on that date.

For N.M. RAIJI & CO.  
Chartered Accountants

Mumbai, May 5, 1997

V.V. NERURKAR  
Partner

## 11.8 MAOCARO

In exercise of the powers conferred by Section 227(4A) of the Companies Act, 1956, the Central Government issued the MANUFACTURING AND OTHER COMPANIES (AUDITOR'S REPORT) ORDER, 1988. The Order applies to the auditor's report of specific classes of companies. It requires that the report should include a statement on such matters which have been incorporated in the Order:

### 11.8.1 Applicability

The MAOCARO applies to every company (including a foreign company) engaged or proposed to be engaged in one or more of the following activities:

- (a) manufacturing, mining or processing;
- (b) supplying and rendering services;
- (c) trading; and
- (d) the business of financing investment, chit fund, nidhi or mutual benefits societies.

### 11.8.2 Matters to be Included

The auditor's report on the accounts of a company to which this Order applies should include a statement on the following matters:

#### In the case of a manufacturing, mining or processing company

- i) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets; whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- ii) whether any of the fixed have been revealed during the year? If so, the basis of revaluation should be indicated;
- iii) whether physical verification has been conducted by the management at reasonable intervals in respect of finished goods, stores, spare parts and raw materials?
- iv) are the procedures of physical verification of stocks followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported;
- v) whether any material discrepancies have been noticed on physical verification of stocks are compared to book records, and if so, whether the same have been properly dealt with in the books of account?
- vi) whether the auditor, on the basis of his examination of stocks, is satisfied that such valuation is fair and proper in accordance with the normally accepted accounting principles? Is the basis of valuation of stocks same as in the preceding year? If there is any deviation in the basis of valuation, the effect of such deviation, if material, should be reported;
- vii) if the company has taken any loans, secured or unsecured from specified companies, firms or other parties, whether the rate of interest and other terms and conditions of such loans are prima facie prejudicial to the interest of the company;
- viii) if the company has granted any loans secured or unsecured, to listed companies, firms or other parties, whether the rate of interest and other terms and conditions of such loans are prima facie prejudicial to the interest of the company;
- ix) whether the parties to whom the loans, or advances in the nature of loans, have been given by the company are repaying the principal amounts as stipulated and are also regular in payment of the interest and if not whether reasonable steps have been taken by the company for recovery of the principal and interest;
- x) is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials, including components, plant and machinery, equipment and other assets and for the sale of goods;
- xi) whether the transaction of purchase of goods and materials and sale of goods, materials and services, made in pursuance of stated contracts or arrangements, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials, or services or the prices at which transactions for similar goods or services have been made with other parties;
- xii) whether any unserviceable or damaged stores, raw materials, or finished goods, are determined and whether provisions for the loss, if any, have been made in the accounts;

- xiii) in case the company has accepted deposits from the public, whether the relevant directives and provisions have been complied with. If not, the nature of contraventions should be stated;
- xiv) is the company maintaining reasonable records for the sale and disposal of realisable by-products and scraps, where applicable;
- xv) whether the company has an internal audit system commensurate with its size and nature of its business in the case of companies having specified paid-up capital or turnover;
- xvi) where maintenance of cost records has been prescribed by the Central Government, whether such accounts and records have been made and maintained;
- xvii) is the company regular in depositing Provident Fund and Employees' State Insurance dues with the appropriate authority and if not, the extent of arrears shall be indicated by the auditor;
- xviii) whether any undisputed amounts payable in respect of income-tax, wealth-tax, sales-tax, customs duty and excise duty were outstanding, as at the last day of the financial year concerned, for a period of more than six months from the date they became payable; if so, the amounts of such outstanding dues should be reported;
- xix) whether personal expenses have been charged to revenue account; if so, the details thereof should be reported;
- xx) whether the company is a sick industrial company; if so, whether a reference has been made to the BIFR.

#### In the case of a service company

- i) all the matters specified in clause (A) to the extent to which they are applicable;
- ii) whether the company has a reasonable system of recording receipts, issues and consumption of material and stores and allocating materials consumed to the relative jobs, commensurate with its size and nature of its business;
- iii) whether the company has a reasonable system of allocating manhours utilised to the relative jobs, commensurate with its size and nature of its business;
- iv) whether there is a reasonable system of authorisation at proper levels, and an adequate system of internal control commensurate with the size of the company and the nature of its business, on issue of stores and allocation of stores and labour to jobs.

#### In the case of trading company

- i) all matters specified in clause (A) to the extent to which they are applicable;
- ii) have the damaged goods been determined and if the value of such goods is significant, has provision been made for the loss?

#### In the case of finance, investment, chit fund, nidhi or mutual benefit company

- i) all the matters specified in clause (A) to the extent to which they are applicable;
- ii) whether adequate documents and records are maintained in a case where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities;
- iii) whether the provisions of any special statute applicable to chit fund, nidhi or mutual benefit society have been duly complied with; and
- iv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of the exemption, if any, granted under the Companies Act.

### 11.9 RELEVANCE OF 'IN OUR OPINION'

The words 'In our opinion' in auditor's report show that:

- (a) the auditors have examined the records of a company in such a manner that they have been able to draw conclusions on the reliability or otherwise of the records; and
- (b) the auditors have an implied claim about the application of their professional training, skill and judgement in forming opinions to guide the readers of financial statements.

Further, in our opinion indicates to the reader that the auditor is expressing an opinion and not giving a guarantee. Moreover, the opinion carries considerable weight, because it is the opinion of a competent, independent, honest and professional expert given after a careful investigation of the company's accounting records and financial statements.

### 11.10 TRUE AND FAIR CONCEPT

'True and fair' does not establish absolute accuracy of every figure in the accounts. Some of the figures may be just estimates. 'True' indicates association with the facts. 'Fair' shows freedom from bias. The auditors are expected to consider the accounts as a whole and to form an opinion regarding the overall impression conveyed by these accounts.

The minimum legal requirements in respect of disclosure is that the auditor's report should state whether the Balance Sheet shows a true and fair view of the state of affairs of the company as at the end of the financial year and whether the Profit and Loss Account shows a true and fair view of the profit or loss of the company for the year. In case, however, additional information is relevant to show a true and fair view, the financial statements should disclose it.

The concept of 'true and fair' incorporates auditor's opinion. The major purpose is to state whether the financial statements represent fairly the actual financial position as at the end of the accounting period and the profit or loss for that period. What is true and fair is a matter of an auditor's judgement in the particular circumstances of a case.

Some of the essential aspects of true and fair view are:

- 1 that the Balance Sheet and Profit and Loss Account are drawn up as per relevant statutory provisions;
- 2 that the Balance Sheet and Profit and Loss Account are drawn up on generally accepted accounting principles on a consistent basis;
- 3 that the information contained in the Balance Sheet and Profit and Loss Account is neither an over-statement nor an under-statement in respect of the financial position and the working results;
- 4 that the auditors keep in view not only the position at the end of the accounting period, but also such post-accounting period events which are material in making a better assessment of the position as at the date of the Balance Sheet; and
- 5 that the financial statements convey the requisite information clearly.

### 11.11 CLEAN REPORT AND QUALIFIED REPORT

When the auditor's report is positive, incorporating therein that the accounts show a true and fair view of the state of affairs of the business, it is considered to be a clean report.

A qualified opinion in an auditor's report is an opinion subject to certain reservations. This negative opinion, however must be substantiated by:

- (a) the nature of the qualification; and
- (b) the reasons for the qualification.

A qualified report should not be made unless material issues are involved, or disclosures specifically required by law are not disclosed. Any qualification or reservation in an auditor's report must be followed by the reasons why the auditors were unable to perform their duties as per the generally accepted procedures and standards.

Circumstances which give rise to a qualification of opinion in auditor's report generally fall into two categories:

- (a) **Uncertainty** — When there is uncertainty which prevents the auditors from forming an opinion on a matter; and
- (b) **Disagreement** — When the auditors are able to form an opinion on a matter, but this conflicts with the view given by the financial statements.

This means that the auditors may give a qualified report under the following circumstances:

- 1 When the accounts of the company do not show a true and fair view of the state of affairs;
- 2 When the accounts have not been prepared in accordance with the provisions of the Companies Act;
- 3 When proper books of account have not been kept;
- 4 When proper returns have not been received from branches not visited by the auditors;
- 5 When the accounts are not in agreement with the books; or
- 6 When the auditors fail to obtain all the information and explanation that are, in their opinion, necessary for the purposes of their audit.

### 11.12 SOME GUIDING DECISIONS

- 1 It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the Balance Sheet, but to see that it is a true and accurate representation of the company's affairs. (**Leeds Estate Building and Investment Co. vs Shepherd, 1887**)
- 2 An auditor must be honest — that is, he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes that what he certifies is true. An auditor who does not report to the shareholders the facts of the case when the Balance Sheet is not properly drawn up, is guilty of misfeasance. (**London and Central Bank, 1895**)
- 3 It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. (**Kingston Cotton Mill Co. Ltd., 1896**)
- 4 When the reports of the auditors are not communicated to the shareholders, directors are responsible for the lapse. Auditors' duties are discharged when their reports are delivered to the company. It is the duty of the directors to summon the shareholders' meeting and to see that the report of the auditors is read at the meeting. (**Allen Craig & Co. Ltd., 1934**)
- 5 The auditor must come to an audit with an enquiring mind — not suspicious of dishonesty, but suspecting that somebody may have made a mistake somewhere and that a check must be made to ensure that there has been none. (**Formento Ltd. vs Selsdon Ltd., 1958**)

#### Check Your Progress B

- 1 Enumerate three qualities of a good auditor's report.

.....  
 .....

.....  
 .....  
 2 State two circumstances that give rise to a qualified report.  
 .....  
 .....  
 .....

3 Fill in the blanks.

- i) MOACARO stands for Manufacturing and ..... Companies (Auditor's report) Order, 1988.
- ii) The words 'in our opinion' indicates that the auditor is expressing an opinion and not giving a .....
- iii) In the expression 'true and fair', 'true' indicates facts and 'fair' shows freedom from .....
- iv) When the auditor's report is not communicated to the shareholders, ..... are responsible for the lapse.
- v) An auditor who does not report to the shareholders the facts of the case when the balance sheet is not properly drawn up is guilty of .....

**11.13 LET US SUM UP**

An auditor's report is a valuable aid to the company and its shareholders. The Companies Act requires the auditor to make his report on the accounts examined by him. The report is to state whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Act in the specified manner. He reports not merely on the Balance Sheet, but on the accounts which he is required to examine. He is also required to state whether proper books of accounts as directed by law have been kept by the company. The books, however, should be so kept as to give a true and fair view of the state of affairs of the company and explain its transactions.

An auditor's report is not a certificate of accuracy of accounts, when the auditors feel fully satisfied about the accounts and statements being a true representative of the financial position of the company, they give a clean report. In case they find that owing to one reason or the other, the financial statements do not show a true and fair view of the state of affairs of the company, they may qualify their report.

**11.14 KEY WORDS**

**Clean Report :** A report which incorporates the satisfaction of the auditors in respect of statutory requirements relating to books of account, profit and loss account and balance sheet.

**Financial Statement :** Profit and Loss Account, Balance Sheet and other documents forming part of the working results of the company.

**Members :** The expression 'members', 'shareholder' and 'holder of shares' are interchangeable terms in the case of companies having a share capital.

**Qualified Report :** When the auditors express an opinion subject to certain reservations, it is a qualified report.

**Report :** Expression of opinion on legally specified matters for circulation among the shareholders and presentation at annual general meeting.

**True and Fair :** The financial position of the company as truly represented by its financial statements incorporating the working results of the business.

**11.15 ANSWERS TO CHECK YOUR PROGRESS**

- A 2 i) False      ii) False      iii) True      iv) False
- v) True
- B 3 i) other      ii) guarantee      iii) bias      iv) directors
- v) misfeasance

**11.16 TERMINAL QUESTIONS**

- 1 State the matters upon which the auditors must form an opinion while preparing their report as laid down in the Companies Act.
- 2 What do you understand by the concept of 'true and fair' in an auditor's report?
- 3 Discuss the relevance of 'in our opinion' in auditor's report.
- 4 Explain the areas in respect of which the auditors must express their opinion.
- 5 Name the circumstances under which a qualified audit report may be necessary.
- 6 To what extent the auditor's report guarantee the accuracy of accounts?
- 7 Distinguish between a report and a certificate.
- 8 State the need for an auditor's report.
9. What is the importance of an auditor's report from the point of view of investors?
10. Identify the qualities of a good audit report.
11. What is MAOCARO? What is its purpose? State the types of companies to which this order is applicable.

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

# UNIT 12 COST AND MANAGEMENT AUDIT

## Structure

- 12.0 Objectives
- 12.1 Introduction
- 12.2 Meaning of Cost Audit
- 12.3 Forms of Cost Audit
  - 12.3.1 Propriety Audit
  - 12.3.2 Efficiency Audit
- 12.4 Objectives of Cost Audit
- 12.5 Difference between Financial Audit and Cost Audit
- 12.6 Advantages of Cost Audit
  - 12.6.1 Cost Audit and Management
  - 12.6.2 Cost Audit and Shareholders
  - 12.6.3 Cost Audit and Society
  - 12.6.4 Cost Audit and Government
- 12.7 Limitations of Cost Audit
- 12.8 Statutory Provisions
- 12.9 Cost Audit Programme
- 12.10 Commencement Considerations
  - 12.10.1 Points for Special Attention
  - 12.10.2 Cost Audit Planning
- 12.11 Cost Audit Report
- 12.12 Meaning and Objectives of Management Audit
- 12.13 Importance of Management Audit and Limitations
- 12.14 Distinctive Features
- 12.15 Preliminary Considerations and Audit Programme
- 12.16 Management Audit Report
- 12.17 Summary
- 12.18 Key Words
- 12.19 Answers to Check Your Progress
- 12.20 Terminal Questions

## 12.0 OBJECTIVES

After studying this unit, you should be able to :

- explain the nature and purpose of cost audit and management audit
- differentiate between financial audit, cost audit and management audit
- describe the advantages and limitations of cost audit and management audit
- specify the relevant statutory provisions governing cost audit
- explain the programme, procedure and report relating to cost audit and management audit
- outline the contents of an audit report relating to cost and management audit.

## 12.1 INTRODUCTION

It is now fully acknowledged that any form of accounting must be closely followed by a suitable system of auditing. This is mainly done to verify the credibility of accounts and their reliability as a basis for various business decisions.

Cost accounting is an essential aid to determination of selling prices and maximising the profitability of the company. But, the costing system should also be competent to avoid

consumer exploitation. It is in this perspective that a system of cost audit is applied to verify the correctness and reliability of cost accounting records.

Management audit, on the other hand, is a process of examining the performance and evaluating the efficiency. It identifies the areas of weakness of internal control and suggests measures for improvement of efficiency.

In this unit, we shall learn about the nature, scope and conduct of cost and management audits including the relevant statutory provisions and the reporting requirements.

## 12.2 MEANING OF COST AUDIT

We have seen earlier that audit is a process of verification and examination. It is often stated that auditing begins where accounting ends, because accounting records form as the basis of verification. Audit exercise is conducted in order to ensure whether the corresponding accounts give a true and fair view of the state of affairs or not.

When the concept of audit is applied to cost accounting records; it means a more specific and specialised activity. Cost audit is defined as "the verification of cost records and accounts and a check on the adherence to the prescribed cost accounting procedures and the continuing relevance of such procedures".

### Main Functions of Cost Audit

On interpreting the above definition, we may outline the following four main functions of cost audit;

- 1 **Verification** as a process of audit;
- 2 **Examination** of the correctness of cost records and accounts;
- 3 **Analysis** whether the prescribed procedures of cost accounting have been properly followed or not; and
- 4 **Evaluation** that the prescribed procedures of cost accounting continues to be relevant to the organisation under audit. This involves an assessment of: (a) adequacy of cost accounting systems, records and procedures, (b) their correct maintenance; (c) their proper compilation in the form of cost statements, and (d) adherence of the prescribed accounting procedures.

## 12.3 FORMS OF COST AUDIT

Cost audit is conducted in addition to the audit of financial accounts by the statutory auditors appointed by the company. It normally addresses itself to two major aspects of a business: protective and constructive, known as Propriety Audit and Efficiency Audit respectively.

### 12.3.1 Propriety Audit

From the protective point of view, cost audit:

- 1 detects errors,
- 2 verifies that the cost accounts are maintained correctly in accordance with generally accepted cost accounting principles adopted in the industry, and
- 3 ensures that the prescribed system of cost accounting is properly carried out.

### 12.3.2 Efficiency Audit

From the constructive point of view, cost audit examines:

- 1 the adequacy and effectiveness of existing procedures in respect of managerial decisions;
- 2 the possibilities of drawing optimum results through the projected expenditure;



- 3 the opportunities of a more profitable investment of money in another area; and  
4 the rate of return on capital employed.

## 12.4 OBJECTIVES OF COST AUDIT

The main objectives of cost audit are as follows:

- 1 to serve as an effective tool of control;
- 2 to safeguard the interest of the members of the company, consumers of its product and the Government;
- 3 to verify the accuracy of costing data;
- 4 to satisfy that the principles of cost accounting have been properly adapted and applied;
- 5 to assist the process of decision-making on the basis of cost considerations;
- 6 to offer suggestions for a more efficient organisation of the costing operations;
- 7 to ensure that the suitable system of costing has been maintained in accordance with the needs and characteristics of the industry and the supporting procedures help the attainment of the goals of the organisation;
- 8 to examine whether the cost statements give a true and fair view of the cost information;
- 9 to help ascertainment of quotations for future contracts based on correct cost estimates;
- 10 to look into the cost practices as an effective aid to pricing decisions; and
- 11 to act as a moral check on the employees associated with cost accounts.

Cost audit, thus, is a valuable tool of verification of cost information and its control.

## 12.5 DIFFERENCE BETWEEN FINANCIAL AUDIT AND COST AUDIT

The major areas of difference between financial audit and cost audit are as follows:

	FINANCIAL AUDIT	COST AUDIT
1	Compulsory for every company registered under the Companies Act.	Applicable to certain categories of companies only.
2	Auditor's Report covers financial statements like the Profit and Loss Account and Balance Sheet.	Scope of reporting remains confined to cost accounting records only.
3	Vouching is the primary technique of audit exercise.	The enquiry is primarily to find out if the expenses really contribute to production.
4	Takes into account actual transactions of receipts and payments.	Cost records based on estimates need to be verified.
5	Includes valuation of assets and liabilities.	Only the adequacy of stock is judged.
6	Protects the interest of the shareholders.	Protects the interest of the management and consumers.
7	Concentrates upon books of account	Looks into the utilisation of labour, material and other items of cost.

- |    |  |  |
|----|--|--|
| 8  | It is a regular annual audit.                              | It may be for a particular year only.                    |
| 9  | Helps ascertainment of correct profit or loss.             | Suggests methods to reduce wastage and increase profits. |
| 10 | Auditors are appointed by the shareholders of the company. | Appointed by the Board of Directors of the company.      |
| 11 | Examines transactions which have previously taken place.   | It is a forward-looking approach.                        |

A financial audit, therefore, covers a wider field. Cost audit is in respect of a particular and specified activity of the company.

## 12.6 ADVANTAGES OF COST AUDIT

Let us now discuss the advantages and importance of cost audit from the viewpoints of -

- (a) the management,
- (b) the shareholders,
- (c) the society, and
- (d) the Government.

### 12.6.1 Cost Audit and Management

Cost audit:

- 1 guides managerial decisions through relevant cost data;
- 2 assists regulation of level of production;
- 3 detects and prevents errors and frauds;
- 4 checks wastage and minimises cost;
- 5 fixes accountability for poor performance;
- 6 helps in improving procedures and their efficiency;
- 7 compares actual cost with estimated cost and analyses causes of variance;
- 8 evaluates comparative profitability of different units;
- 9 extends moral influence on staff; and
- 10 ensures application of proper principles of costing.

### 12.6.2 Cost Audit and Shareholders

Cost audit ensures:

- 1 a system of accounting for expenses;
- 2 a method of proper utilisation of resources;
- 3 an efficient process of production; and
- 4 an adequate return to investors

### 12.6.3 Cost Audit and Society

Cost audit aids:

- 1 ascertainment of true cost and fair selling price;
- 2 determination of level of industrial efficiency and its contribution to economic development; and
- 3 adoption of a proper standard of living due to fixed price-level.

**12.6.4 Cost Audit and Government**

Cost audit is a tool of:

- 1 tariff policy on different industrial units;
- 2 subsidy decisions in respect of industrial operations;
- 3 regulated prices and profits;
- 4 controlled industrial sickness;
- 5 enforcement of fair trade practices;
- 6 finding out future project costs;
- 7 guidance to proposed levy of taxes and duties;
- 8 improved efficiency of industrial operations; and
- 9 quicker settlement of industrial disputes.

Thus, cost audit is an useful form of expertise which contributes to effectiveness of operations involved in the production of goods or services. It has both internal and external advantages.

**12.7 LIMITATIONS OF COST AUDIT**

Cost audit also has its limitations. These are as follows:

- 1 Cost audit is an undue interference in the internal operations of the management.
- 2 Cost records serve as an important instrument of facing market competition and the relevant information must be treated as trade secrets.
- 3 Cost audit is a verification of accounts of estimated figures only which are invariably different from actual expenses.
- 4 It is a pretty time-consuming exercise. Verification spreads over the entire fields of activity and deals with numerous items of production process ranging from the first purchase of raw materials to the last sale of finished product.
- 5 Cost audit may take much time to complete and its reports may be out-dated. They may be mere history when they come up for consideration.

Despite such limitations, cost audit is a recognised technique of control and industrial efficiency. Its importance and scope of application, therefore, have been continuously growing.

**12.8 STATUTORY PROVISIONS**

In respect of cost audit, the major provisions of section 233 B of the Companies Act, 1956 (as amended) are as follows:

**1 When Cost Audit is Required?**

The Central Government may, if it feels necessary, may direct by an order that an audit of cost (records kept by as under section 209 (1) (d) company shall be conducted in such manner as may be specified in the order by an auditor. It may be noted that the cost audit is in addition to statutory financial audit.

**2 Who can Conduct Cost Audit?**

The auditor for this purpose shall be a cost accountant within the meaning of the Cost and Works Accountant Act, 1959. If the Central Government is of opinion that sufficient number of cost accountants are not available for conducting the audit of cost accounts of the companies generally, the Government may allow for specified period that duly qualified chartered accountants may also conduct the cost audit.

**3 How to Appoint Cost Auditor?**

A cost auditor is to be appointed by the Board of Directors of the company with the previous approval of the Government.

**4 Is Cost Audit an Additional Audit?**

A cost auditor is separate from a financial auditor. A cost audit is in addition to audit conducted by an auditor under section 224 of the Act.

**Check Your Progress A**

**1 What is Cost Audit?**

.....  
 .....  
 .....

**2 State three objectives of Cost Audit.**

.....  
 .....  
 .....

**3 Who can be appointed as a Cost Auditor?.**

.....  
 .....  
 .....

**4 State whether the following statements are True or False :**

- i) From the protective point of view cost audit detects errors.
- ii) From the constructive point of view cost audit prevents errors.
- iii) Cost auditor is not a tool of verification of cost information.
- iv) Cost audit fixes accountability for poor performance.
- v) Cost audit is a superfluous exercise.
- vi) Cost auditor is appointed by the Board of Directors.
- vii) Cost audit is an external audit.
- viii) Cost audit is a regular annual audit.

**12.9 COST AUDIT PROGRAMME**

A Cost Audit Programme is a coordination of:

- (a) the work to be done,
- (b) its distribution among the audit staff, and
- (c) the time-frame to complete the assignment.

The Companies Act, however, has not laid down any specific method of cost audit. The only provision is that under the directed circumstances, the cost auditor is required to submit his report to the Central Government with a copy to the company under audit. But a cost audit programme must have a systematic plan of action so that it is concluded within the time schedule and at minimum cost.

The cost audit programme includes the following verifications:

- 1 Whether the policies followed by the company in its interest?
- 2 Whether the cost accounts maintained by the company in order?
- 3 Whether the management has been efficient enough to generate adequate profit to the company or to control its cost of production?
- 4 Whether his audit opinion is going to be based on facts duly supported by proper examination of relative records?

Besides, the cost audit programme should also take note of:

(a) audit methodology to be applied, (b) audit notes prepared, (c) questionnaires issued, (d) queries made, (e) replies received, (f) explanations collected, (g) additional information required, (h) discussions held, (i) follow-up measures needed, etc.

## 12.10 COMMENCEMENT CONSIDERATIONS

Before the cost auditor actually begins his work, his attention should be directed towards the following:

- 1 Nature and size of business;
- 2 Method of recording receipts and issue of materials;
- 3 Maintenance of stores records, including supplies to different departments, units, jobs or contracts;
- 4 Process of checking the quality and value of materials received and issued;
- 5 Measures to prevent losses, wastage or shortage of goods;
- 6 Types of product, their installed capacity and actual output; and
- 7 Organisation structure and levels of delegation of authority.

The system of stores control also needs proper examination before the commencement of cost audit. This helps identification of the strengths and weaknesses of the system which governs the subsequent audit approach. Cost audit, therefore, does not follow any standard pattern. It has to adapt itself to specific situations.

### 12.10.1 Points for Special Attention

Points which need special attention in course of cost audit are as follows:

- 1 Date of first commencement of commercial production;
- 2 cost accounting system in existence and its adequacy to determine correctly the cost of production;
- 3 Cost of major raw materials consumed both in terms of quantity and value;
- 4 Incentive schemes with particular references to its contribution towards increasing productivity and its effect on cost of production;
- 5 method of depreciation adopted by the company;
- 6 Reasons for any significant variations in the expenditure incurred against overheads as compared with the previous two years; and
- 7 Any abnormal features affecting production during the year, eg. strike, lock-out, plant break-down, power-cut, accident etc.

### 12.10.2 Cost Audit Planning

However, Planning and execution of cost audit are guided by the following considerations:

- 1 Objects of the assignment of cost audit,
- 2 Quality of costing system in use in the organisation,

- 3 Strength of internal control mechanism adopted by the management,
- 4 Size of the transactions involved in production, and
- 5 Type of managerial decisions and their relevance.

The Companies Act has not prescribed any specific method to conduct cost audit. It has not given any such procedure which may be followed by the auditors. The Central Government, however, may issue instructions regarding the points to be covered by the cost auditor while notifying his appointment. The auditor is then expected to follow such instructions.

## 12.11 COST AUDIT REPORT

The Cost Audit (Report) Rules, 1968 (as amended from time to time) incorporate the following major provisions:

- 1 **Submission of Report:** Every cost auditor who conducts an audit of the cost accounting records of the company is to make a report to the central Government in the prescribed form and according to the prescribed procedure, and at the same time will forward a copy of the report to the company.
- 2 **Powers and Duties of Cost Auditor:** The company and its every officer shall make available to the cost auditor such cost accounting records, cost statements and other books and papers that would be required for conducting the cost audit, and shall render necessary assistance to the cost auditor so as to enable within the specified time limit.
- 3 **Time Limit for Report:** The cost auditor shall send his report to the Central Government and to the company within 180 days from the end of the company's financial year to which the cost audit report relates.

The form prescribed for Cost Audit Report is as follows.

### COST AUDIT REPORT

I/We ..... having been appointed as auditor (s) under section 233-B of the Companies Act, 1956 of M/S. .... Ltd., have examined the books of accounts and other relevant records for the year ended ..... relating to maintained by the company and report subject to my/our comments under the heading "Auditor's observations and conclusions contained in the Annexure to this Report".

- (a) I/We have obtained all the information and explanations which to the best of my/our knowledge and belief were necessary for the purposes of this audit;
- (b) proper cost accounting records have been kept by the company;
- (c) proper returns adequate for the purpose of my/our cost audit have been received for branches not visited by me/us;
- (d) the said books and records give the information required by the Act in the manner so required; and
- (e) in my/our opinion the company's cost accounting records have been properly kept so as to give a true and fair view of the cost of production, processing, manufacturing or mining activities as the case may be, and marketing of the product under reference.

The matters contained in the Annexure to this Report form part of this report, which is also subject to my/our observations made therein.

Dated this ..... day of ..... 19..... at .....

Cost Auditor(s)

The cost audit report includes annexures in respect of the following information about the company:

- 1 General particulars about the company,
- 2 Cost accounting system existing in the company,
- 3 Financial position, eg. capital employed, net worth, profit, etc.,
- 4 Production capacity and actual output,
- 5 Process of manufacture,
- 6 Raw materials' cost and quantity,
- 7 Quantity and cost of power and fuel consumed,
- 8 Wages and salaries paid,
- 9 Stores and spare parts per unit of output,
- 10 Rate and method of depreciation,
- 11 Overheads,
- 12 Royalty or technical aid payments,
- 13 Sales, and
- 14 Abnormal non-recurring costs.

The cost audit report further gives relevant observations and conclusions of the auditor in respect of budgetary control system, scope and performance of internal audit, etc. and may make suggestions for improvements in performance of various activities.

If, as a result of the examination of the books of account the auditor desires to give a qualified report, he should indicate the extent to which he has to qualify the report and the reasons thereof.

### 12.12 MEANING AND OBJECTIVES OF MANAGEMENT AUDIT

We have learnt about the nature and characteristics of financial audit and cost audit. Let us now discuss a relatively new concept of auditing viz., management audit. You know management is a combination of functions. It is a responsibility. It includes not only formulation of policies but also their execution.

Management Audit is a process of examination and evaluation of the performance of managerial functions. It also covers the organisational structures of a company. It involves a critical review of policies, processes, procedures and operations which form part of the internal control system. It analyses the effectiveness in the utilisation of different resources. Management audit, thus is an appraisal of both policies and actions.

According to Leonard, "management audit is a comprehensive and constructive examination of an organisational structure of a company, institution or branch of Government, and components thereof such as a division or department, and its plans and objectives, its means of operations and its use of human and physical facilities".

Management audit, in effect, investigates into the soundness of management and its efficiency of operations. It is an assessment of the systems which are being used in an organisation. It identifies areas of weakness in internal control and suggests measures to improve performance.

#### Objectives

The main objectives of management audit are as follows:

- 1 to promote organisational efficiency;
- 2 to enhance operational profitability;

- 3 to encourage an effective involvement and participation of staff in attaining the goals of the management;
- 4 to discover deficiencies or irregularities in the system and suggest appropriate measures for best possible results;
- 5 to assist the achievement of targets fixed by the management;
- 6 to help development of harmonious relationships both within and outside the organisation; and
- 7 to facilitate performance evaluation of resource inputs.

### 12.13 IMPORTANCE OF MANAGEMENT AUDIT LIMITATIONS

You have learnt that management audit involves:

- (a) Identification of areas of weakness, points of inefficiency and ineffectiveness of policies;
- (b) Verification of factors of production, cost components, centralisation and decentralisation of administration, system of business operations, defects of organisational structure, quality of finished products, causes of sickness, and such other areas of management; and
- (c) Submission of an improved approach to working based on better productivity and management control.

Thus, management audit is a valuable aid to achievements such as:

- 1 Reduction in wastage and cost of production;
- 2 Effective translation of policies into action;
- 3 Improved profitability;
- 4 Optimum utilisation of resources;
- 5 Performance evaluation of various activities; and
- 6 Review of actual results rather than procedures.

#### Limitations

Management audit, however, has also some demerits. The limitations often indicated in this regard are:

- 1 that management audit discourages initiative and dynamism;
- 2 that it tries to find undue faults in the working of the system;
- 3 that it fails to serve any material purpose; that it is an unnecessary interference in the system of administration;
- 4 that it is an unnecessary interference in the system of administration;
- 5 that it involves additional cost; and
- 6 that its recommendations may be ideological and difficult to implement.

These criticisms of management audit are, however, not considered to be valid. If such audit is conducted with independence and objectivity, its report is useful not only to management but also to its employees, customers and the Government.

### 12.14 DISTINCTIVE FEATURES

Let us now distinguish between Financial Audit, Cost Audit and Management Audit. The main areas of difference between these three concepts are as follows:

- 1 Scope**
- Financial Audit is an effort to ensure a true and fair view of the state of affairs of a company represented through its Profit and Loss Account and Balance Sheet for the period.
  - Cost Audit ensures that the cost accounting system followed in the organisation serves as a true basis of ascertainment of cost of production.
  - Management Audit examines the efficiency of almost every area of operation within the organisation.
- 2 Approach**
- Financial Audit is a process of verification of past records of accounting relating to a previous year.
  - Cost Audit takes into view the current system of cost computation.
  - Management Audit mainly applies its attention to future planning and performance.
- 3 Object**
- Financial Audit aims at detection and prevention of errors and frauds.
  - Cost Audit examines the reliability of the systems which produce cost information.
  - Management Audit is an attempt to assess efficiency and suggest its further improvement.
- 4 Technique**
- Financial Audit uses the techniques of vouching, verification and valuation for the purpose of forming an opinion.
  - Cost Audit examines the records of materials, labour and other expenses as components of total cost of operation.
  - Management Audit determines the adequacy of procedures and control adopted by the organisation.
- 5 Status**
- Financial Audit is a statutory audit.
  - Cost Audit is an audit of cost ascertainment and control.
  - Management Audit is a policy audit and efficiency audit, but not a statutory obligation.
- 6 Frequency**
- Financial Audit is conducted regularly every year.
  - Cost Audit is conducted as per the instructions issued by the Central Government.
  - Management Audit is conducted as per the needs and desires of the company.
- 7 Method**
- Financial Audit is a verification of transactions recorded in the books of account.
  - Cost Audit evaluates economy and output.
  - Management Audit examines systems, policies, performance and organisation to identify weaknesses and suggest remedy.
- 8 Responsibility**
- Financial Audit reports about the actual state of affairs pertaining to financial position as on a particular date.
  - Cost Audit confines itself to cost implications of operations.

- Management Audit is concerned with the performance profitability of the organisation.
- 9 Task**
- Financial Audit begins where the work of accountancy ends.
  - Cost Audit covers both the record of actual expenses incurred as well as the estimated cost of materials, labour and other items.
  - Management Audit begins where the work of financial audit ends.
- 10 Appointment**
- Financial Audit is conducted by a qualified Chartered Accountant.
  - Cost Audit is conducted by a qualified chartered or cost accountant with the prior approval of the Central Government.
  - Management Audit may be conducted by any independent expert or consultant.
- 11 Emphasis**
- Financial Audit is interested in the accuracy of operational results rather than in their adequacy.
  - Cost Audit checks the correctness of costing system and techniques.
  - Management Audit is an appraisal of activities, identification of possible areas of inefficiency and measures to improve future performance.

## 12.15 PRELIMINARY CONSIDERATIONS AND AUDIT PROGRAMME

Before the commencement of a management audit, it may be useful to have the following considerations:

- Review the objectives and goals of the organisation in order to assess the possibilities of getting the desired results through them;
- Observe the exercise of authority and find out if it crosses the prescribed limits;
- Check the effectiveness and reliability of the channels of communication;
- Verify the credibility of the sources of information;
- Examine the efficiency and economy of utilisation of resources;
- Ascertain the steps taken to safeguard assets;
- Identify the suitability of policies, plans and procedures;
- Judge the adequacy of internal control systems and their compliance;
- Compare standard performance and actual performance;
- Study the relevant documents, seek explanation and supplement statements;
- Collect information relating to:
  - adequacy of organisational structure,
  - suitability of plans and targets,
  - gaps between proposals and performance,
  - accountability and responsibility,
  - obstacles in smoothness of operations,
  - causes of variance between results, and
  - level of compliance of prescribed procedures.

A management Audit Programme as a proposed schedule of operations should cover the following major areas of examination to be covered under a management audit programme are as follows:

- 1 adequacy of organisation and its structure;
- 2 effectiveness of plans and objectives;
- 3 enforcement of policies and procedures;
- 4 soundness of systems and methods;
- 5 suitability of techniques of control;
- 6 efficiency of operations in maximisation of output;
- 7 usefulness of plant and equipment;
- 8 utilisation of manpower towards productivity;
- 9 cooperation between workers and management; and
- 10 compliance of relevant rules and regulations.

Besides, the main steps before audit are to establish a clear picture about the unit through the following questions:

- 1 Are the plans adequate to achieve the objectives?
- 2 Are the branches of management at least at par with other similar organisations in the field?
- 3 Are the systems of control efficient?
- 4 Are the protective methods suitable?
- 5 Are the policies and procedures being followed faithfully?

A preliminary approach to audit helps the auditor to correlate information, summarise observations, draw conclusions and offer suggestions for efficiency of operations.

### 12.16 MANAGEMENT AUDIT REPORT

Though there is no prescribed form of management audit report, it should normally incorporate the opinion of the auditor on the following matters:

- 1 Whether the rate of return on capital subscribed by the shareholders adequate and reasonable;
- 2 Is the current rate of return on investment satisfactory when compared to that of the last year?
- 3 In comparison to the operating costs of other similar units, what is the position in the organisation under audit?
- 4 Is the existing plant and equipment capable of giving optimum production?
- 5 Is the level of relationship between the management and staff and workers happy and harmonious?

Moreover, a good report on management audit should be –

- (a) based on facts, correct statements guided by right information;
- (b) compact, concise and clear;
- (c) critical but polite;
- (d) constructive and specific;
- (e) practical and positive in suggestions;
- (f) true assessment of operations; and
- (g) contribution to further efficiency in the organisation.

A management audit report, therefore, should be an aid to future control and performance effectiveness.

### Check Your Progress B

- 1 Define Management Audit.  
.....  
.....  
.....  
.....
- 2 State three limitations of Management Audit.  
.....  
.....  
.....  
.....
- 3 Fill in the blanks.
  - i) Management audit investigates into the soundness of management and its efficiency of .....
  - ii) Management audit tries to find ..... in the working of the system.
  - iii) Management audit is not a ..... obligation.
  - iv) Management audit begins where the work of ..... audit ends.
  - v) Management audit reports acts as a ..... to future and performance effectiveness.

### 12.17 SUMMARY

Cost and management audits are supplementary forms of audit. These are conducted in the required circumstances in addition to the normal financial audit under the provisions of the Companies Act.

A cost audit is an examination of cost records and cost accounts so as to determine their reliability in managerial decisions. A management audit is an evaluation of the organisation, its policies, its performance, its efficiency and the prospects of its improved profitability.

These two forms of audit, therefore, are much relevant to the needs of internal control and operational audit. When areas of weakness are identified and appropriate action is taken to remove such weaknesses, the entire system becomes more efficient, policies more practicable, assets more safe and records more dependable. All this contribute not only to credibility of accounts, but also to productivity of operations.

Both cost audit and management audit now receive wider recognition and increasing adaptation in modern organisation of a developing nature.

### 12.18 KEY WORDS

**Cost Audit :** Verification of cost records and examination of cost accounting procedures.

**Efficiency Audit :** Cost audit addressed to the constructive aspect of a business.

**Internal Control :** The entire system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner.

**Management Audit :** A process of examination and evaluation of the performance of managerial functions in an organisation.

**Propriety Audit :** Cost audit addressed to the protective aspect of a business.

---

### 12.19 ANSWERS TO CHECK YOUR PROGRESS

---

- A 4 (i) True, (ii) False, (iii) False, (iv) True,  
(v) False, (vi) True (vii) True (viii) False
- B 3 (i) Operations (ii) Faults (iii) Statutory (iv) Financial  
(v) Control

---

### 12.20 TERMINAL QUESTIONS

---

- 1 What is Cost Audit? What are its objectives?
- 2 Differentiate between financial audit and cost audit.
- 3 State the advantages and limitations of cost audit.
- 4 Enumerate the points that need special attention in course of cost audit.
- 5 What are the various points that should be incorporated in a cost audit report?
- 6 What do you understand by management audit? How does it help management in improvement of its effectiveness.
- 7 Distinguish between financial audit and management audit.
- 8 What are the major areas of examination involved in management audit?

**Note :** These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

---

### SOME USEFUL BOOKS

---

Porwal & Kapoor, *Auditing, Theory and Practice*; Kitab Mahal, Allahabad, (Chapters 12,17)

Pagare, *Principles and Practice of Auditing*. Sultan Chand & Sons, New Delhi, (Chapter 16).

Sharma Dr. T.R. 1989. *Auditing*. Sahitya Bhawan; Agra, (Chapters 11,15 & 16).

Kamal Gupta and Ashok Arora. *Fundamentals of Auditing*. Tata Mc Graw Hill Publishing Co., Ltd. New Delhi (Chapters 7, 20).

Martin T.P., 1994. *Audit Management*, South Asia Publications, Delhi.