AUDITING

M.Com (Accountancy)
Semester – III, Paper-IV

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson- writers of the Centre who have helped in these endeavors.

Prof. P. Raja Sekhar
Vice-Chancellor (FAC)
Acharya Nagarjuna University

306CO21: AUDITING

SYLLABUS

UNIT-I: INTRODUCTION: Basic Principles of Auditing: Evolution of Auditing - Development of Auditing since Independence; Accounting and Auditing; Objectives of an Audit; Ethical Principles of Auditing, Detection and Prevention of Errors and Fraud. Qualities of an Auditor.

UNIT-II: AUDITING AND ASSURANCE STANDARDS: An Overview, Standards setting Process, Guidance Notes, Auditing and Assurance Standards in India; Differences Between Auditing & Assurance Standards and International Standards of Auditing; Role of Auditing and Assurance Standards Board of India.

UNIT-III: ORGANISATION OF AUDIT: Audit Planning, Letter of Engagement; Preparation for Audit, Audit Program, Audit Note Book, Audit Working Papers, Audit Files, Audit Manual and Audit Evidence, Delegation and Supervision of Audit work.

UNIT-IV: INVESTIGATION OF ACCOUNTS: Differences between Auditing and Investigation - Investigation Features and Reasons, Guiding Principles and Stages of Investigation - Representation by Management as Audit Evidence, Documentation of Representation by Management.

UNIT-V: AUDITOR'S REPORT AND LIABILITIES: Object and Importance, Audit Report and Audit Certificate, Types of Audit Reports, Contents of Audit Report, Special matters to be considered in Auditing Report; Requisites of a good Audit Report; Liability of Joint Auditors, Liability of Honorary Auditor, and Liability of an Auditor appointed by Private and Public Limited Company, Specimen of Qualified Audit Report, Legal views as regard Audit Report.

FURTHER READINGS:

1. Kamal Gupta & Ashok Gupta, "Fundamentals of Auditing", McGraw Hill Education, New Delhi, 2004.

2. R.G. Saxena, "Principles and Practice of Auditing", Himalaya Publishing House, New Delhi, 2011.

3. Spicer and Pegler. "Practical Auditing", Allied Publications, 5th Edition, New Delhi.

4. Ghatalia, Principles of Auditing, PHI, New Delhi.

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LESSON - 1

INTRODUCTION

1.0. Object : After going through this lesson the student can know what is auditing ? What are the objects and advantages of Auditing ?

Structure :

1.1. Introduction :

The practice of auditing accounts may be traced back to the early stages of civilisation. In those days audit was undertaken mainly for state or public accounts. The historical records of auditing show that ancient Egyptians, Greeks and the Romans used to get their public accounts audited. Audit of accounts of Private business houses was rare as the size of the business houses was small and management and ownership were joint.

The system of accounting and auditing is believed to have existed in our country under the Mauryas, Chandra Gupta and other Hindu Kings. Kautilya, in his Arthashastra had mentioned about the accounting and auditing of state finance. He also listed various kinds of frauds and prescribed punishments to deal with them. However, the growth of the Accounting Profession in India is of a recent origin.

Auditing as it exists today can be associated with the introduction of large scale production as a result of Industrial revolution during the 18th century.

The introduction of joint stock form of organisation widened the scope of investment and business activities. Business community started raising money from public and also borrowed capital from various private and state financial institutions. Under company form of organisation the investors called as shareholders delegate the management of the undertaking in which they have invested their money to a Board of Directors but they would be keenly interested in the safety of their investment. As the shareholders are drawn from far off places and are not at the helm of the affairs of the company. In these circumstances need for getting the accounts audited arose.

The Indian companies Act had made it compulsory for all the corporate bodies to get their accounts audited by qualified professional accountants.

1.2. Definition:

The word audit is derived from the Latin word 'Audire' which means " 'to hear'. In olden days whenever the owners of the business suspected fraud they appointed certain persons to check the accounts. The auditor use to hear the accounts of the parties relating to financial transactions. It was in fact a cash audit. But Now-a-days the auditor verifies the accounts to find out their accuracy. Thus the modern audit is not merely a cash audit but also an audit of final accounts.

'Auditing' means an examination of the accounts books and the relative documentary evidence by an independent qualified person in order to ascertain the accuracy of the figures appearing there in.

Some of the definitions given by different writers are given below :

Montgomery a leading American accountant and auditor, has define auditing as "a systematic examination of the books and records of a business or other organisation in order to ascertain or verify and the report upon the facts regarding the financial operations and the results thereof".

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

According to Dickse "auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate. But this is not the end of the matter, in addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined whether they portray a true and fair picture".

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

After going through the above definitions in simple words we may say that auditing is a critical and intelligent examination of the books of accounts with relevant vouchers and documents to ascertain whether the profit or loss shown by the profit & loss account and financial position as shown by the balance sheet are fair and true.

1.3. Objects of an Audit :

The main object of an audit is to find out after going through the books of accounts whether the Balance sheet and profit and loss account are properly drawn up according to the companies Act and whether they represent a true and fair view of the state of affairs of the concern. Detection and prevention of errors is the subsidiary object of modern audit.

Thus in general auditing may be defined as "Science of verifying the records and reports which reflect the financial condition and operating results of the business."

1.3.a. Verification of Accounts and statements :

The primary object of an audit is to establish, by an examination of books, vouchers and other appropriate records that the balance sheet, at a given date, is properly drawn up so as to exhibit a true and fair view of the state of affairs of the business and the profit and loss account discloses the correct profit or loss for the period. His primary object always is the establishment of the degree of reliability of the annual statements of accounts.

An audit is also intended to disclose how far the system of accounting which is being followed has been successful in correctly recording the transactions as well as the weaknesses that there may be in its organisation. The companies Act requires an auditor to report whether books of accounts are kept in accordance with the Act and whether they show a true and fair view of the state of affairs of the company.

1.3.b. Detection and prevention of Errors :

A) Error may be defined as "Mistake of negligence or misjudgment without an intention to fraud."

Audit aims at finding out errors if any in the accounts. Errors may arise at various stages in Book-keeping records. The errors may arise because of the carelessness of the clerks or their ignorance of the principles of accounts. The former are called clerical errors and the later are called errors of principles, clerical errors are of four kinds.

1) Errors of Ommission

2) Errors of Commission

3) Errors of Duplication

4) Compensating errors

1) Errors of Ommission :

These errors arise when any transactions are not recorded in the books either wholly or partially. Complete omission will not effect the Trail Balance. So the auditor has to take special care to detect such ommission. Ommission to enter purchases in the purchases book, omission to enter sales in the sales book and non Provision for outstanding expenses are some of the examples of complete ommission . Partial ommission will effect the trail balance. So the auditor can detect them easily. These errors affect the accounts and profit and loss account materially. They may even effect Balance sheet.

2) Errors of commission :

These are most common. These errors arise when any transaction is incorrectly recorded or posted. They consists of wrong entries postings, castings and calculations and carry forwards. Most of these errors will affect the agreement of trail balance. So they can be detected by a cautious routine checking. But errors in calculations will not affect the agreement of the trail balance. So detection of such errors is not easy.

3) Errors of Duplication :

These errors arise when any transaction is entered twice in the books of original entry and posted twice in the ledger. They will not cause the disagreement of trail balance. So detection is not easy.

4) Compensating Errors :

A compensating error may arise when errors counter act each other. It is a dangerous type of error. It may or may not affect the profit and loss account of the business. It will not affect the agreement of trail balance so detection is not easy. For example X account was credited by Rs.200 instead of Rs.800. There was a short credit of Rs.600, while Z account is debited by Rs.200 instead of Rs.800. Thus there is a short debit of Rs.600. It means that there was a short credit and short debit of Rs.600 each. Here one error was exactly counter balancing an other error. These errors are also known as off setting errors because the effects are off-set.

Errors of principle :

These errors arise when transactions are not recorded in the books of accounts according to the accepted principles of accountancy. These errors may be committed purposely or accidentally. They will not affect the trail balance but they will affect the profit and loss account and balance sheet to a great extent. The auditor must always be on the look out for such errors. These can be detected by searching enquiry and independent checking.

Wrong valuation of assets,wrong distribution of expenditure between capital and revenue, incorrect provision for depreciation or bad and doubtful debts are some of the examples of errors of principle.

Location of Errors :

The question is how to locate an error if the trail balance does not agree and the auditor is called upon to locate the error although it is not his duty to do so. The following steps will ease the work.

1) Check the totals of the trail balance.
2) Compare the names of the accounts in the ledger with the names of the accounts as have been recorded in the trail balance.
3) Total the lists of debtors and creditors and compare them with the trail balance.
4) If the books are maintained on the self balancing system, see that the total of different accounts agrees with the total of these accounts with the balance of accounts as recorded in the trail balance.
5) Compare the items of the trail balance, halve it and see if there is any item of this value. This is done to avoid the putting of the debit balance on the credit side of the trail balance or vice Versa.
6) Compare the items of the trail balance with the items of the trial balance of the previous year to see if any item has bee ommitted.
7) It is possible that the totals of some subsidiary books e.g : cash book, purchases book, sales book etc; might not have been transferred to the trail balance. Re-check the totals of these books.
8) If an error is divisible by 9 may be due to misplacement e.g. writing 32 as 23.

Detection of Frauds :

Frauds are planned and intentional errors with a view to defraud. Detection of fruad is more difficult than the detection of errors. Detection of fraud depends upon the efficiency of the internal check in operation. As a rule, frauds can be detected easily in the early stages. But it is difficult to detect them if they assume complications. The scope for committing fraud depends upon the supervision of the proprietor division of work and the system of internal check in operation.

Frauds may be committed mainly to three ways.

1) By misappropriation of money.

2) By misappropriation of goods

3) Manipulation of accounts.

Cash can be misappropriated in two ways, 1) By ommission of receipts by acknowledging a lesser amount than what actually received. 2) By inclussion of fictitious payments or recording more payments than actual payments. Ommission of receipts can be detected by checking the debit side of the cash book and sales mans dairy, counterfoil of receipt book etc.

Goods which are less bulky but more valuable can be easily misappropriated. Detection of such misappropriation is not easy. The success of detection depends upon the accuracy of stock records.

Accounts are manipulated to conceal the real position of the concern. It is usually committed by directors of managers or other responsible officials with the object of showing more profit than what actually they are to sell the shares at high prices by declaring high dividends to obtain further credit by showing the financial position of the business better than what actually it is or to attract more subscribers for the sale of shares of the company etc.

Prevention of errors and frauds is possible only by application of sound system of internal check and suitable management of the concern. The auditor must suggest methods to the management for preventing the recurrences of errors and frauds in future.

1.4. Advantages of an Audit :

On account of the following advantages people get their accounts audited.

1. Errors and frauds are located at an early date and in future no attempt is made to commit such frauds.
2. The auditing of accounts keeps the accounts clerks regular and vigilant in their work.
3. In case of fire the insurance companies may settle the claim on the basis of audited accounts of the previous years.
4. Money can be borrowed easily on the basis of previous audited Balance Sheet.
5. If the business is to be sold as a going concern there will not be much difficulty regarding the valuation of assets and goodwill as the accounts have already been subject to audit by an independent person.
6. Income tax authorities generally accept the profit and loss account which has been prepared by a qualified auditor and they do not go into the details of accounts.
7. The management may consult the auditor and seek his advice on certain technical points although it is not the duty of an auditor to give advice.
8. Accounts of one year can be compared with other years and if there is any discrepency the causes may be enquired into.

9. The audited accounts are considered more or less correct by the sales tax authorities.

10. It would facilitate the settlement of the accounts of a deceased partner.

11. An auditor acts as trustee of the shareholders and safeguard their financial interest in the case of a joint stock company. Shareholders are assured that the accounts have been properly maintained and the directors and managers of the company have not taken any undue advantages of their position.

12. Audit safeguards the interest of the workers because audited accounts are useful for settling trade dispute for higher wages or for payment of bonus to the workers.

1.5. Qualities of an Auditor :

The person who conduct audit is known as the auditor. He makes a report to his appointing authority after careful examination of the accounting records and the accounting statements. In this report he expresses his opinion whether the statements of account are true and fair or not. For this purpose the auditor need the following qualities.

1) It is very important for an auditor to be well versed in the fundamental principles and theory of all branches of accounting; ex : Financial Accounting, cost accounting; Income tax etc. It is not possible for a person to audit the accounts unless he himself knows how to prepare them. He should not pass a transaction unless he himself knows that it is correct. This is possible only when one knows thoroughly well the principles of accounting.

2) He should be able to grasp quickly the technical details of the business whose accounts he is auditing. If possible he should pay a visit to the works of his client before he commences his work.

3) He should be prepared to seek elucidiaton technical questions rather than show a false pride or fear of displaying his own ignorance.

4) He should quite familiar with the company and mercantile laws and must be complete master of the principles of auditing.

5) He must be tactful and honest as Lord Justice Lindley has said "An auditor must be honest i.e. he must not certify what he does not believe to be true and he must take reasonable care and skill before he believes what he certifies is true”. (In London & General Bank).

6) He must not be influenced directly or indirectly by others in discharging his duties.

7) Sometimes he is put in a very ackword position when his duties to his client is opposed to his own interest in which case he must have the courage to carry out his duty faithfully, and honestly even if such a step harms him.

8) He must be prepared to resign rather than sign a Balance Sheet which he knows does not exhibit a true and fair view of the state of affairs of a concern and thus gives a false report.

9) He should not disclose the secrets of his client.

10) He must have the tact to put some intelligent questions to extract full information.
11) He must be prepared to hear the arguments and must be reasonable.
12) He must be vigilant, cautious, methodical and accurate.
13) He should have an understanding of the general principles of Economics.
14) He should have thorough training in business organisation, management and finance.
15) He should have common sense and the ability to write the report clearly, correctly, concisely and forcefully.
16) An auditor need not be unduly suspicious. As Lord justice Lopes said, "An auditor is not bound to be a detective or to approach his work with suspicion or with foregone conclusion that there is something wrong." (In Kingston Cotton Mills Co. case)

1.6. Distinction between accountancy and auditing :

Accountancy may be defined as the science as well as the art of recording business transactions in the financial books. The person who is concerned with the recording of business transactions in the financial books is known as an accountant. He maintains accounts and prepares the profit and loss account and Balance Sheet but he will not give guarantee of the correctness of the accounts which he prepares. He will not certify the Balance Sheet as true and fair, he can only say that the Balance Sheet is in accordance with the books. He will not certify the Balance Sheet as true and fair, he can only say that the balance sheet is in accordance with the books.

Accountancy is quite distinct from auditing. The following are the main differences between accountancy and auditing.

Accouantancy	Auditing
1) Accountancy is concerned with the writing of books or the prepration of accounts.	1) Auditing is concerned with the examination of such books or accounts to ascertain their accuracy.
2) Accountancy is primarily constructive and concerned with recording of business facts	2) Auditing is analytical and essentially retrospective in nature.
3) Accoutancy is the original work.	3) Auditing presupposes the existence of accounts. It gives finishing touch to accounts. An audit commences after the accounting are ready. It is said that audit really begins where accountancy ends.
4) Accountancy involves the preparation of final accounts.	4) An auditor verifies their accuracy and certifies that they represent a true and fair view of the state of affairs of the concern. Thus the auditor verifies what the accountants have done.
5) No qualification is prescribed for the accountants of a joint stock company. Any person having specialised knowledge of the principles of accountancy is eligible for appointment as an accountant of a joint stock company.	5) But only persons who satisfy the qualifications prescribed by the Indian Companies Act are eligible for appointment as auditor of joint stock companies.

Distinction between Accountancy and Auditing is of great importance. An auditor must clearly know as to whether he is working in the capacity of an auditor or accountant.

In the case of Apfel Vs Anna Dexter & Co (1929), it was sought to prove that the auditor had acted in the capacity of auditors and therefore, they were liable for negligence in detection of a fraud.

The auditors contention was that they were employed to prepare the books of accounts for Income tax purpose and not to do the work of an audit. The certificate given by the auditors was prepared from the books of "Mrs. Adele Apfel and in accordance there with". But they had sent the bill for costs which was worded as "for services in connection with the preparation and audit of your accounts".

From the certificates given by the auditors it is clear that the work done by them was of a purely accountancy nature while the bill sent by them was both of accountancy and auditing. Austbury J. gave the judgement in favour of the auditors taking into consideration the object and the purpose for which the auditors were employed.

In the case of commissioner of Income tax Madras Vs G.M. Dandekar 1956. It was held by the Madras High court that the auditor was employed to prepare incometax returns and did not act in the capacity of the auditor of his employer.

1.7. Summary :

Auditing is a critical and intelligent examination of the books of accounts with relevant vouchers and document to ascertain whether the profit or loss shown by the profit and loss account and financial position as shown by the balance sheet are fair and true. Detection and prevention of errors is the subsidiary object of modern audit. Errors are of two types clerical errors and principle errors. Error may be defined as a mistake or misjudgement without an intention to defraud the concern. A Fraud may be defined as intentional errors with the object to defraud the concern. It is compulsory to audit the account of a joint stock company. The auditor must distinguish his duties whether he has been appointed as an accountant or an auditor.

1.8.Self Assessment Questions :

1. Define an "Audit" and state the various objects of an audit.
2. What are the different types of frauds in connection with accounts ?
3. Distinguish accountancy and auditing ?
4. What are the essential qualities required of an auditor apart from the statutory qualifications.
5. Write short notes on the following :

a) Location of errors

b) Detection and prevention of errors.

c) Detection and prevention of frauds.

6. What are the advantages of an audit ? Briefly state the qualities of an auditor.

7. What are the main objects of an audit ?

1.9. Recommended books

Principles of Auditing	**:**	**R.G. Saxene**
Principles & Practices of Auditing	**:**	**B.N. Tandon**
Principles & Practices of Auditing	**:**	**Jegadish Prakash**
Contemporary Auditing	**:**	**Kamal Gupta**

-Dr. Ch. Suravinda

LESSON - 2

TYPES AND CONDUCT OF AUDIT

2.0. Object : After going through this Lesson the student can know the various types of Audit and How it is conducted ?

Structure :

2.1. Introduction :

It is not obligatory to the sole traders or partnerships, under law, to get their accounts audited but because of the advantages derived they generally have their accounts audited.

2.2. Various Types of Audit :

Audit may be of different classes but the principal classes of audit are :

1) Audit under statute (Law);

2) Audit of the accounts of private individuals;

3) Audit of the accounts of private firms;

4) Audit of the accounts of trustees and executors etc.

2.3. Audit under statute :

Audits are compulsory in the case of undertakings mentioned below, under the different laws that govern them

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

b) Banking companies governed by the Banking companies Regulation Act, 1949.

c) Insurance companies governed by the Insurance Act, 1938.

d) Co-operative societies registered under the co-operative societies Act.

e) Public and charitable Trusts registered under various religious and other endowment Acts.

f) Local authorities and govt. undertakings.

Audit is of two types it may be a statutory audit or general audit. It is not compulsory to any partnership firm or sole trading concern to get their accounts audited, but it is optional, such an audit is known as general audit. When an auditor is asked to audit the accounts of a firm he must get clear instructions in writing from his client to know the scope of his work.

Audit is compulsory in case of joint stock company according to the company Act. The audit of accounts of a joint stock company is known as statutory audit.

Advantages :

1) The share holders of a company have no access to the books of accounts and therefore if the accounts are audited by an auditor who is an independent professional accountant, they are assured that they have not been defrauded.

2) An audit act as a check upon the dishonest employees whose number may be very large.

Distinction between the audit of a joint stock company and a firm :

Joint Stock Company	Firm
1) The audit of Joint stock company is compulsory under the companies Act.	1) Audit is not compulsory in case of partnership firm.
2) The duties, powers, rights etc, of an auditor of a joint stock company are defined by the Companies Act.	2) They depend upon the agreement between the auditor and firm.
3) He must be a qualified person as laid down under (Sec.226)	3) He need not be a qualified person.

Here the student must also know the difference between audit of government offices, and commercial undertakings. The book keeping system as is adopted by the commercial concerns is not followed in government offices although their objectives may be the same. The audit system in government offices is therefore not similar to that of the commercial concerns. First of all we will discuss the objectives of the government Audit.

Objectives of government Audit :

The objectives of government Audit are as follows :

1) To see whether there is a provision of fund for the expenditure and whether such a fund has been duly authorised by competent authority.
2) To see that the expenditure has been properly sanctioned according to the rules and regulations.
3) To see whether the sanctioned expenditure has been incurred by an officer competent to incur such an expenditure.
4) To see that the amount has been paid to the proper person and the relative receipt has been obtained.
5) To see that the payment has been properly and correctly classified.
6) To see whether the payment is to be debited to the personal account of a contractor or an employee.
7) To see while auditing the receipts that money due from others is regularly recovered and checked against payment already made and the amount received is duly credited to the account concerned.
8) To see while auditing the stores and stocks, whether they are properly and accurately valued.
9) To see that the stock taking of the stores is periodically done or such stores may be verified with the balance as shown in the stock Register.
10) To see that the expenditure confirms to the general principles like, that the expenditure is not more than what is necessary and that every Government servant has exercised reasonable care to spend the money; and the public money is not utilised for the benefit of a person or section.
11) To see that the allowances should not become a source of profit to the receipient.

Distinction between the Audit of Government Accounts and Commercial Concern :

The following are some of the important distinctions between government audit and commercial audit.

Government Audit	Commercial Audit
1) The audit of government transactions, whether in or outside India is entrusted to the Audit and Accounts department which is quite independent of the spending department. It compiles of the major portion of the accounts which it audits.	1) In the case of commercial firms the auditor never prepares the accounts which he has to audit.
2) The spending department in case of Government offices, itself performs a part of the work incidental to audit as the audit officer has no knowledge of the quantity or quality of work done by a contractor or goods supplied by the supplier etc.	2) In the case of commercial concerns the audit work is not performed by the spending department.

3) Treasury officer who is not a member of the Accounts and Audit Department, makes the preliminary examination of the bills while making the payment on Government accounts.	3) In case of commercial firms, the cashier has nothing to do with the audit or preliminary examination of the bills which are paid by him.
4) A government audit is continuous audit because of a very large number of transaction and also because a large part of the work is concerned with the personal claims of Government officers and which have to be finalised with greate speed.	4) Commercial Audit is, in a majority of cases periodical.

2.4. Audit of the Accounts of a private individual :

Sole proprietors are not required by any law to have their accounts audited. Despite this fact it is quite usual for many of them who receive their incomes from different sources and whose expenditure is vast and varied, to get their private accounts audited. In such cases the auditor acts as an accountant also and prepares the accounts besides checking their accuracy. When he is appointed by an individual, he must get clear instructions from his client in writing as to what he is expected to do. His scope of work will depend upon the agreement that he has entered into with the client. In case the auditor is asked to do the full audit he must see that the accounts are properly prepared and the Balance sheet is correctly drawn-up in order to avoid his responsibility.

Advantages :

The following are the advantages to be derived by private individual by getting his account audited :

1) The individual is assured of having his accounts properly maintained and there is no fraud of any type by the accountant.
2) The audited accounts are generally taken as correct by the income-tax authorities for fixing the tax payable.
3) The audited books of a deceased are very helpful to the executors and administrators in preparation of the death duty accounts.
4) Wealth tax can be properly assessed.
5) The appointment of an auditor keeps a check on the accounts department.

2.5. Audit of the Accounts of Private Firms :

It is not necessary that the accounts of a firm should be audited but since there are many advantages of getting the accounts audited, many firms generally makes a provision for audit in the Partnership Deed. In such a case an auditor is appointed by an agreement between the auditor and his client. He should always bear in mind that all the partners jointly and severally are his clients, though he might have been appointed by only one of them, if so authorised under the partnership deed. He must get in writing the nature and scope of his work which is to be carried out and should make a written report in turn which can leave no doubt as to the nature of duties undertaken.

Advantages :

The following are the advantages to be derived by a partnership firm by getting the accounts of a firm audited by a qualified auditor.

1) Disputes among partners may be avoided.
2) In the case of admission, retirement or death of a partner, the valuation of goodwill and the settlement of accounts may become very easy.
3) Audited accounts will be more reliable for the purpose of assessment of income-tax.
4) Negotiations for loan from different sources become easy.
5) Auditor can suggest better ways of keeping the accounts.

In addition to the above mentioned particular advantages, a firm derives all the advantages which are usually derived in getting the accounts audited.

2.6. The Audit of Trust Accounts :

Trusts are created for the benefit of some religious or charitable institutions such as temples and educational institutions. In some cases trusts may be created for the benefit of Minors and widows who cannot look after the property themselves. The trustees took after the property left over by the testator. They collect the rents of the property, dividends on the shares etc., and distribute the income to the beneficiaries according to the terms of the Trust Deed. In many cases these trustees may not have the necessary knowledge of maintaining accounts or may not use the income of the trust for the benefit of the party for which it has been created. In other words, they may misappropriate the trusts funds without the knowledge of the beneficiaries. To avoid such a thing, generally a provision is made in Trust Deed for audit of accounts by a qualified auditor. If the accounts are audited, it helps both the trustees and the beneficiaries. Trustees will be benefited because there will be no unnecessary criticism against them, and the beneficiaries will be assured about the correctness of the accounts.

2.7. Conduct of an Audit :

An audit may be

1) Continuous Audit
2) Periodical Audit
3) Interim Audit
4) Occassional Audit
5) Partial Audit
6) Standard Audit
7) Balance sheet Audit

Now we will go through with each of the conduct of Audit and their relative advantages and Disadvantages one after the other.

1) Continuous Audit :

It is also called a detail audit which involves a detailed examination of books of accounts at regular intervals of say one month or three months. The auditor visits his clients at regular or irregular intervals during the financial year and checks each and every transaction. At the end of the year he checks the profit and loss Account and Balance sheet.

Businesses where continuous Audit is Applicable :

1) To those concerns where it is desired to present the accounts just after the close of the financial year as in the case of a bank.
2) Where the volume of transactions is very large.
3) Where the statement of account is required to be presented to the management after every month.
4) Where no satisfactory system of internal check is in operation.

Advantages of continuous Audit :

1) Errors and frauds can be discovered easily and quickly as the auditor checks the accounts at regular intervals and in detail.
2) Since the auditor remains more in touch with the business he is in a position to know the technical details of it and hence can be of great help to his clients by making valuable suggestions.
3) Most of the checking was having been already performed during the course of the year, the final audited accounts can be presented to the shareholders soon after the close of the financial year at the annual general meeting.
4) As the auditor visits the clients at regular intervals, the clerks will be very regular in keeping the accounts up-to-date.
5) If the auditor pays surprise visits it will have a considerable moral check on the clerks preparing accounts.
6) The auditors having more time at his disposal can check the accounts with great attention and in detail, so his work will be more efficient.
7) Where the directors of a company wish to declare an interim dividend continuous audit will help in the preparation of the interim accounts without much delay.
8) Audit staff can be kept busy throughout the year.

Disadvantages :

1) The figures in the books of accounts which have already been checked by the auditor at his previous visit may be altered by a dishonest clerk.
2) The frequent visits by the auditor may dislocate the work of his client.
3) It is an expensive system of audit.

4) The audit clerk may loose the thread of his work thus continuous audit lacks continuity in work.

5) The staff of the client may depend upon the audit staff to help them out of difficulties in the course of their work.

6) Extensive note taking may be necessary in order to avoid any alteration in the figures after the audit.

These disadvantages may be avoided by taking the following precautions.

1) No alteration shall be allowed to be made after the entries have been checked.

2) If any alteration has to be made it should be done by means of rectifying entry in Journal.

3) Checking of a book should be complete as far as possible in one visit to avoid loose ends. However if this is not possible he should check the transaction upto a particular date and make a note of it in his dairy.

4) If any alteration in a figure had already been made, the auditor should put a secret tick against such a figure.

5) He should pay surprise visits to the clients office.

2.9. Periodical or final audit :

Periodical audit is one which is taken up at the close of the trading period, when all the accounts have been balanced and trading and profit and loss Account and Balance sheet prepared. The audit is completed in one continuous session. In this case the auditor visits his client only once in an year and goes on checking the accounts until the audit work for the whole of the period is completed.

If the auditor has several clients whose financial year ends on the same date, it may be difficult for the auditor to complete the work of all his clients

Though this type of audit is called complete or Detailed Audit the expression is not correct because each and every transaction is seldom checked in a big business house. This type of audit is suitable to small concerns where the number of transactions are small in number.

2.10. Distinction between Final Audit and continuous Audit :

Continuous Audit	Final Audit
1) The auditor visits his staff frequently and check the accounts.	1) The auditor visit the client only at the end of the year and check the accounts in a single sitting.
2) Accounts are audited as and when recorded .	2) Accounts are audited after the preparation of final accounts.
3) It is suitable to big concerns and where a detailed checking is necessary.	3) It is suitable to small concerns.
4) It is an expensive one.	4) It is relatively cheap.

2.11. Interim audit :

It is an audit which is conducted in between the two annual audits with a view to find out interim profits to enable a company to declare an interim dividend.

Advantages :

1) This type of audit is good where the publication of the interim figures is necessary.
2) The final audit can be completed very soon, if there has been an interim audit.
3) Errors and frauds can be more quickly found and detected during the course of the year.
4) There is a moral check on the staff of the client as the accounts are checked say after three or six months.

Disadvantages :

1) Figures may be altered in the accounts which have already been audited.
2) It will mean that the audit staff will have to prepare notes when they finish the interim audit.
3) This is an additional work.

Distinction between continuous Audit and Interim Audit :

For better understanding of the interim audit and continuous audit the following points of distinction between them is provided to the students.

Continuous Audit	Interim Audit
1) The work of audit is carried on up to any date according to the convenience of the auditor and his client.	1) The work of audit is up to a definite date according to the instructions of the client.
2) Verification of assets and liabilities is done after the balance sheet has been prepared at the end of the accounting period.	2) The Assets and liabilities are verified when this audit is conducted.
3) No trail balance is prepared though the totals of certain accounts may be noted.	3) The trail balance has to be prepared or checked.
4) The object is not to know the profit or loss.	4) It is conducted to know the profit or loss.

2.12. Partial Audit :

When an auditor is asked to check some of the records and books for a part or whole of the period, it is called partial Audit eg : he may be asked not to check the payment side of the cash book. Partial audit is not permitted in the case of private or public limited companies.

2.12. Balance sheet Audit :

It is an audit to verify the items appearing in the Balance sheet and the profit and loss Account. It is a limited audit in which all the balance sheet accounts i.e. assets liabilities, reserves and provisions are verified. Those items of profit and loss account are only checked which are directly related to assets. In this kind of audit, work like vouching, casting and posting etc, is dispensed with. This type of audit can be successful in those business houses where efficient system of internal check and control is in operation. This type of audit is popular in U.S.A.

2.13. Occasional Audit :

This type of audit is conducted once a while and that too at the desire of the owner of the business. For example, the audit is not compulsory in case of sole proprietor and partnership business but whenever the need arises the proprietors can get the accounts audited.

2.14. Summary :

Audit is compulsory to certain concerns which is known as statutory audit and it is optional to sole trading concerns and partnership firm, so it is called general audit. Each type of Audit has its own advantages and disadvantages. The type of audit to be adopted depends upon the magnitude of the business.

2.15. Self Assessment questions :

1) Give the objectives of audit of government accounts.
2) What is meant by continuous audit and to what type of business it is specially applicable ?
3) State the merits and demerits of continuous audit.
4) What is periodical audit and what are the advantages and disadvantages of periodical audit.
5) Distinguish continuous audit and periodical audit.
6) Distinguish between an audit under statute and other audits.
7) Write a shortnote on various types of audits and their relative advantages.

2.16. Recommended books :

Principles of Auditing	:	**R.G. Saxene**
Principles & Practices of Auditing	:	**B.N. Tandon**
Principles & Practices of Auditing	:	**Jegadish Prakash**
Contemporary Auditing	:	**Kamal Gupta**

-Dr. Ch. Suravinda

LESSON: 3

STANDARDS SETTING PROCESS AND GUIDANCE NOTES

OBJECTIVES:

The objectives of this lesson are:

- To determine and apply knowledge of Auditing Standards to your professional practice and/or further study.
- To understand the requirements of each Standard to conduct Audit in Accordance with Standards.
- To provide an overview of auditing standards and guidance notes issued by the Institute from time to time.

STRUCTURE

3.1 HISTORICAL RETROSPECTS OF STANDARDS SETTING PROCESS

The Institute, since its inception, has been committed to research in the field of accountancy. As early as in 1955, the Council set up the Research Committee. The Council at that point of time felt the necessity to establish such a committee to deal with the growing complexities of the problems faced by membership at large and with a view to ensuring the highest of traditions and technical competence in the discharge of the duties by chartered accountants.

As back as in 1964, the Council published the "Statement on Auditing Practices" as prepared by the Research Committee not only for the benefit of its members but also for others outside the profession, who might be interested in this subject. It was hoped that this Statement would provide valuable guidance in the performance of audits, particularly of companies.

The Council of the Institute fully realised that techniques of accounting and auditing had undergone changes and shall further undergo changes as the business environment are changing. Since the members were expected to keep pace with recent developments, this Statement attempted to set out practices which were generally accepted in other countries and which the Council considered desirable in the light of prevailing circumstances in India. The issuance of the Statement on Auditing Practices might be considered as a path break as far as establishing sound auditing practices is concerned.

3.2 THE PROCESS TO SET UP AUDITING STANDARDS

To bring uniformity in auditing & assurance services standards are required. These standards not only serve as a guide to auditors but also bring confidence to users to financial statements in it.

International auditing & assurance standards board (IAASB) issue the standard on auditing for companies operating outside the U.S.

To set up auditing standard following process is adopted:

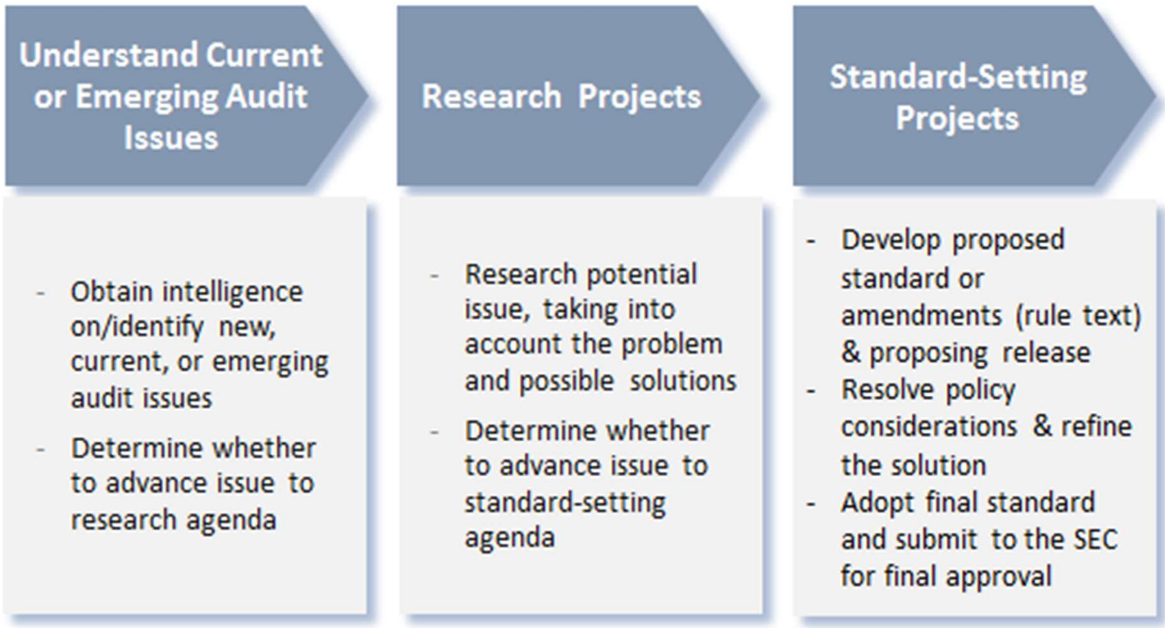
- **Identifying the issue:** In this process, stakeholders are asked to about the issues faced by them. Hence, everyone including an organization preparing financial statements, any govt. agency or all other users who use financial statements play a role in the preparation of auditing standards.
- **Finding out a solution to issue:** Various professionals engaged in the field of accountancy and auditing do research to find out the solution of identified issues.
- **Drafting standard:** After comprehensive research, a draft standard is prepared to deal with an ongoing issue.
- **Setting up standards:** This drafted standard is finally submitted to the SEC for final approval.

3.3 PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

The PCAOB(Public Company Accounting Oversight Board, Washington, D.C.) seeks to establish and maintain high quality auditing and related professional practice standards for audits of public companies and other issuers, and broker-dealers in support of the PCAOB mission to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB Office of the Chief Auditor - working with other PCAOB offices and divisions - assists the Board in establishing and maintaining PCAOB standards.

The PCAOB standard-setting activities include identifying current or emerging audit issues, developing the research agenda, and working on standard-setting projects. These are informed by a range of activities, such as the PCAOB's oversight, monitoring and outreach activities, discussion with SEC staff, the work of other standard setters (for example, the International Auditing and Assurance Standards Board), and other relevant inputs and developments.

The PCAOB takes a priority-based approach to standard-related projects. The timing of each phase may vary from project to project, depending on the nature and scope of audit issues involved. A high-level overview of the standard-setting process follows.



Understand Current or Emerging Audit Issues: The process begins with an environmental scan to identify current or emerging audit issues to inform the Board about matters that potentially warrant changes to PCAOB standards or that warrant additional staff guidance. The staff continues to monitor current or emerging issues, including observations from oversight activities, that may merit further consideration. The evaluation of potential issues may result in a project being added to the research agenda.

Research Projects: For each research project, an interdivisional research team is formed to perform research, outreach, and economic analysis to assess whether there is a need for changes to PCAOB standards; consider alternative regulatory responses; and, if standard setting is needed, evaluate the potential standard-setting scope and approaches. If standard setting is pursued, the project would be added to the standard-setting agenda. If standard setting is not pursued, consideration would be given to whether any other action is needed. For example, the staff may prepare guidance regarding the application of existing PCAOB standards.

In addition to the projects on the research agenda, the staff also conducts monitoring activities in other areas that could impact audits or PCAOB standards (e.g., financial reporting fraud, auditor independence, and new accounting standards).

Standard-Setting Projects: For each standard-setting project, the PCAOB solicits public comment on potential changes to standards before adopting changes. Consideration of changes to standards also involves conducting an economic analysis and analyzing the potential impact of changes on audits of emerging growth companies. Staff Guidance on Economic Analysis in PCAOB Standard Setting (Feb. 14, 2014), was prepared to provide guidance to staff involved in rulemaking.

3.4 INTERNATIONAL STANDING-SETTING BOARDS

Setting high-quality international standards that inspire confidence in economies. The work of the international, independent standard-setting boards supports the global economy and financial markets by producing high-quality, global standards for audit and assurance, professional ethics, public sector financial reporting, and professional skills and competencies.

3.5 ACCOUNTING STANDARDS AND STANDARDS ON AUDITING

The 'accounting standards' and 'Standards on Auditing' establish standards which have to be complied with to ensure that financial statements are prepared in accordance with generally accepted accounting standards and that auditors carry out their audit in accordance with the generally accepted auditing practices. They become mandatory on the dates specified in the respective document or notified by the council. There can be situations in which certain matters are covered both by a 'Statement' and by an 'Accounting Standard'/ 'Standards on Auditing. In such a situation, the 'Statement' prevails till the time the relevant 'Accounting Standard'/ Standards on Auditing becomes mandatory. Once an 'Accounting Standard'/ 'Standards on Auditing' becomes mandatory, the concerned 'Statement' or the relevant part thereof automatically stands withdrawn.

Standards on Auditing (SAs) establish standards, which have to be complied with to ensure that auditors carry out their duties in accordance with the generally accepted auditing practices. They become operative (i.e., mandatory) in respect of audit of all enterprises on the dates specified in the respective SAs or notified by the Council. The duties of the members of the Institute in relation to operative SAs are similar to those in respect of 'Statements' relating to auditing matters.

KEY ASPECTS OF THE STANDARD ON AUDITING

Some of the underlying principles of the Standards on auditing are elaborated below:

(i) Risk Based Auditing: The standards of auditing issued by the ICAI require the auditor to perform a 'Risk Based Audit'. In a risk-based audit, the auditor seeks to obtain a reasonable assurance that no material misstatements whether caused by fraud or errors exist in the financial statements. Risk based auditing primarily involves the following steps:

- Assessing the risks of material misstatement in the financial statements
- Designing and performing further audit procedures that respond to assessed risks and reduce the risks of material misstatements in the financial statements to an acceptably low level
- Issuing an appropriate audit report based on the audit evidence obtained.

The Standards on Auditing requires the auditor to consider the following rebuttable presumed risks of material misstatement:

(a) That there are risks of fraud in revenue recognition
(b) Risks related to management override of controls

(ii) Scalability: The standards on auditing issued by the ICAI are applicable to audit of all entities. That is, the nature, size, legal form of the entity is irrelevant while applying these standards. Simply put: "An Audit is an Audit". The International Federation of Accountants (IFAC) has in its Policy Position 2 mentioned that "IFAC considers that high quality auditing standards should be, and in fact are, capable of being applied to the audits of the financial statements of entities of all sizes."

Internationally, there is an increased discussion regarding developing separate set of standards on auditing for audit of Small and Less Complex Entities. However, revised standards issued by the International Auditing and Assurance Standards Board like ISA 315 and ISA 540 reinforce the concept of scalability while including additional application guidance specific to audits of smaller, less complex entities.

(iii) Professional Skepticism: SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" defines Professional Skepticism as "An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence". In addition to SA 200, at least 10 other standards such as SA 240, SA 300, etc. emphasize on the need for maintaining professional skepticism while conducting the audit.

(iv) Professional Judgement: An audit requires the auditor to perform procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. The auditor applies professional judgement in deciding which procedures are to be performed. This requires the auditor to rely on their knowledge, training and experience and professional skepticism. Standards on Auditing assist the auditor in proper and optimum discharge of their profession duties and promote uniformity in practice as also comparability. However, these standards do not discourage the use of judgement by the auditors.

(v) Materiality: The standards on auditing refer to the concept of materiality. Information is considered material if its omission or misstatement has the potential to influence the economic decisions of users taken on the basis of the financial statements. Materiality is relative to the size and particular circumstances of individual companies. Determining materiality involves the exercise of professional judgment by the auditor.

(vi) Audit Evidence: Standards on auditing in the series 500-599 provide detailed guidance on obtaining sufficient and appropriate audit evidence. This includes guidance on external confirmations, sampling, specific areas such observation of physical verification of inventories, accounting estimates, related parties among others.

The standards on auditing require assessment of going concern assumption (SA 570) and also verify subsequent events (SA 560). In view of clause (xix) of the revised CARO 2020, these two concepts/ standards have become more relevant than before.

It is important for the auditor to obtain suitably tailored management representation letters (SA 580). While representation letter is not a substitute for more persuasive audit evidence, in certain matters such as existence of off-balance sheet items, contingent liabilities, the auditor may have little choice to rely on representation letter to safeguard himself/ herself.

(vii) Documentation: Audit Documentation is the record of audit procedures performed (including audit planning), relevant audit evidence obtained, and conclusions the auditor reached. Terms such as ‘working papers’ or ‘workpapers’ are sometimes used for audit documentation.

While SA 230 “Audit Documentation” provides detailed and general guidance on the audit documentation, most standards on auditing require specific documentation to be done by the auditor. Given the increased scrutiny by various regulators, it is important for the auditor to have robust documentation of the work done. The cardinal principle is “Work not Documented is Work not Done”!

Reporting: The ultimate objective of an audit is to give an audit opinion on the financial statements. SA 700 (Revised) provides the basic structure of an audit report. This format is applicable to audit reports on the financial statements of all entities including companies, trusts, partnership firms, etc.

Based on the audit evidence obtained, auditor’s assessment thereof and professional judgement, the auditor may issue either an unmodified (commonly referred to as ‘clean’) or a modified audit opinion. Most people refer to an audit opinion as either ‘clean’ or ‘qualified’! However, modifications may be either a ‘qualified opinion’, an ‘adverse opinion’, or a ‘disclaimer of opinion’. These are explained in detail SA 705 (Revised). In some situations, the auditor may include an ‘emphasis of matter ‘(‘EOM’) paragraph- which generally draws attention to a significant matter in the financial statements not warranting a modified opinion but assist the user of financial statements to make an informed decision. The concept of EOM is covered by SA 706 (Revised).

Compliance with a large number of standards on auditing may be an onerous task specially for small practitioners and also in case of audit of small and less complex entities.

ICAI on its part has issued Implementation Guides on various standards on auditing to assist the auditor in applying these standards.

A large number of reviews by the Quality Review Board has highlighted non-compliances with these mandatory standards on auditing. Moreover, due to increase in number of frauds, there is an increased scrutiny, and the auditors are 'on the radar' of most regulators. There are allegations of dereliction of duty by the chartered accountants. This is not only resulting in actions against chartered accountants but also affecting the credibility of the practicing-chartered accountants.

Compliance with standards on auditing together with other authoritative pronouncements, and most importantly adequate documentation is the only way the auditor can defend the audit opinion. The auditors can undermine the importance of standards on auditing only at their own risk.

3.6 AUDITING & ASSURANCE STANDARDS

3.6.1 Auditing - Auditing is required for all financial practices regulations such as auditing of an individual's financial record for taxation purposes. Auditing also regulates dishonest business activities, improper utilization of the fund, misrepresentation of the financial statements, embezzlement, etc. Moreover,
There are generally two types of Audits:

1. Internal Audits: It is usually conducted by the accountants to make sure that all the financial recordsare in compliance with standards in the organization. The company may outsource the auditing service to another external company specialized in this type of evaluation. So that the firm may obtain an unbiased view of its financial statements.
2. Independent Audits: An audit is conducted by the certified public accountant or chartered accountant who scrutinizes the financial books and business transactions of a company with which he is not affiliated. The purpose of an independent audit to conflicts of interest and maintain the integrity of the audit standard.

3.6.2 Assurance- The motive of assurance is not to correct the issues in accounting records but to measure the appropriateness as per accounting standards, principles and follow its compliance. Moreover, assurance is applied to other aspects such as to assess the procedures and processes followed in operations. In such a case, processes and operations are closely observed and assurance will be provided whether the process is being conducted on the basis of the specified procedure to obtain optimum results.

Assurance setting body IAASB has classified separate standards for each of the three subclassified assurance engagement. Any engagement that can fulfil the below-mentioned assurance engagement criteria as follows:

- Three party relationship
- Subject matter
- Criteria
- Gathering appropriate evidence
- Expression of opinion

An appropriate measure that is required for an assurance engagement to be an audit engagement should be a reasonable level.

3.6.3 Differences between Auditing vs Assurance:

The major differences between Auditing vs Assurance:

	Auditing	Assurance
1	A process of evaluating, accounting information presented in statements.	A process of analyzing and assessing processes, operations, procedures, etc.
2	The aim is to present the financial information, reports, fairly, accurately, and ethically accepting accounting standards and principal.	The aim is to ensure the accuracy of accounting information and records to all stakeholders that there are no red flags, misrepresentations, or irregularities in the report.
3	The rights and liabilities of an auditor is higher.	An auditor has comparatively lesser rights than an audit.
4	The audit is in line with the international auditing standards.	Assurance terms may restrict the practitioner only to a specific area.
5	The audience includes generally all stakeholders.	Restrict to just one type of stakeholder for example management.
6	The Time & resources required are higher.	The time and resources are required comparatively less than an audit.
7	Internal control or auditing or external third party helps to enhance the reliability of the information.	Assurance is the step that follows an audit and usually done by a professional auditing body or board.
8	Audit reveals any misuse of the fund and any dishonest activity in financial statements and gives accurate information.	Assurance follows an audit and gives true information to the stakeholders for better decision-making.

Audit vs Assurance are the processes that are linked to each other and are utilize most in evaluating a company's financial records and its performance. Audit vs Assurance are linked to each other both processes are used to verify the information on the company's accounting standards and principles. Assurance is the next move to the audit while an audit is processed internally by the company' account officer or external agency specialized in audits. Even though, assurance is conduct by a professional auditing body or audit board. So there should not be any misrepresentation or red flags in the accounting records and can supply essential information to stakeholders which is necessitate for better decision making.

OVERALL OBJECTIVES OF THE AUDITOR:

In conducting an audit of financial statements, the overall objectives of the auditor are:

- To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

3.7 STATEMENTS

The 'statements' have been issued with a view to securing compliance by members on matters which in the opinion of the council of the institute are critical for the proper discharge of their functions. 'statements' therefore are mandatory. Accordingly, while discharging their attest function, it is the duty of the members of the institute-

(a) to examine whether 'Statements' relating to accounting matters are complied with in the presentation of financial statements covered by their audit. In the event of any deviation from such 'Statements', it is their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations; and

(b) to ensure that the 'Statements' relating to auditing matters, are followed in the audit of financial information covered by their audit reports. If, for any reason, a member, has not been able to perform an audit in accordance with such 'Statements his report should draw attention to the material departures there from.

3.8 GUIDANCE NOTES

Various technical committees of the Institute are involved in the task of issuing guidance notes on topics relating to accounting and auditing for guidance of the members. Some of the important topics in auditing on which guidance notes have been issued are discussed below:

a. Guidance Note on Tax Audit under Section 44AB of the Income-Tax Act:

This Guidance Note was first issued by the Taxation Committee in 1985 and was revised from time to time by the Direct Taxes Committee. Refer to Chapter 12 for a detailed discussion. The clarifications and explanations contained in this Guidance Note are not intended to be exhaustive and the auditors should exercise their professional judgment and experience on various matters on which they are required to report.

b. Guidance Note on Audit of Internal Financial Controls over Financial Reporting: To help the members properly understand and perform the various aspects of reporting responsibility related to audits of internal financial controls over financial reporting, the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India has brought out this Guidance Note on Audit of Internal Financial Controls Over Financial Reporting. The Guidance Note covers aspects such as Scope of reporting on internal financial controls under Companies Act 2013, essential components of internal financial controls, technical guidance on audit of internal financial controls, Implementation guidance on audit of internal financial controls.

The Companies Act, 2013 has introduced some new requirements relating to audits and reporting by the statutory auditors of companies. One of these requirements is given under Section 143(3)(i) of the Act which requires the statutory auditor to state in his audit report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. The section has cast onerous responsibilities on the statutory auditors because reporting on internal financial controls is not covered under the Standards on Auditing issued by the ICAI.

c. GUIDANCE NOTE ON The Companies (Auditor's Report) Order, 2020:

The Central Government, in exercise of the powers conferred, under sub-section (11) of section 143 of the Companies Act, 2013 (hereinafter referred to as "the Act"), issued the Companies (Auditor's Report) Order, 2020, (CARO 2020/ "the Order") vide Order number

S.O. 849(E) dated 25th February 2020. CARO 2020 was initially applicable for audits of financial year 2019-20 and onwards. CARO 2020 contains certain matters on which the auditors of companies (except auditors of those categories of companies which are specifically exempted under the Order) have to make a statement in their audit reports.

The purpose of this Guidance Note is to enable the auditors to comply with the reporting requirements of the Order. This guidance note contains matters on which the auditors of companies (except of those categories of companies which are specifically exempted under the Order) have to make a statement in their audit report.

d. GUIDANCE NOTE(S) ON RELATED SERVICES: The framework for auditing and related services makes it clear that there can be different layers of assurance depending upon the nature of services being performed by the chartered accountant. Related Services comprise of Review engagements, Agreed upon Procedures and Compilation Engagement. Reviews engagements involve providing moderate assurance (or negative assurance) but other two services, viz., and compilation and agreed upon procedures provide no assurance at all. The Institute has issued guidance notes covering these aspects of related services in a comprehensive manner.

e. SQC 1 - QUALITY CONTROL FOR FIRMS THAT PERFORM AUDITS AND REVIEWS OF FINANCIAL STATEMENTS, AND OTHER ASSURANCE AND RELATED SERVICES ENGAGEMENTS

It is a mother Standard for all other Standards and is all pervasive Standard in respect of quality control. As the name suggests, the SQC 1 contains extensive requirements in relation to establishment and maintenance of a system of quality control (QC) in the audit firms as well as even for sole practitioners. The important elements of a system of quality control discussed by the Standard include Elements of a System of Quality Control, Leadership Responsibilities for Quality Within the Firm, Ethical Requirements-Independence, Acceptance and Continuation of Client Relationships and Specific Engagements, Human Resources - Assignment of Engagement Team, Engagement Performance - Consultation, Differences of Opinion, Engagement Quality Control Review and Documentation of the Engagement Quality Control Review - Engagement Documentation.

➢ Introduction

Scope	This Standard on Quality Control (SQC) deals with ¬ A firm’s responsibilities for its system of quality control for Audits and Reviews of financial statements, and other Assurance and related services engagements and ¬ Consists of policies designed to achieve the objective set out in SQC.
Authority	¬ Applicable to all Professional Accountants Firms in respect of audits and reviews of financial statements, and other assurance and related services engagements. ¬ The nature and extent of the policies and procedures will depend on the size and operating characteristics of the firm.
Effective Date	Systems of quality control in compliance with this SQC are required to be established by April 1, 2009

➢ Objective:

The objective of the firm is to establish and maintain a system of quality control to provide reasonable assurance that

(a) the firm and its personnel comply with the respective standards and regulatory and legal requirements; and

(b) Reports issued are appropriate in the circumstances.

➢ Definitions:

In this SQC the following terms have the meanings attributed below:

Engagement team	All personnel performing an engagement, including any experts contracted by the firm in connection with that engagement.
Engagement partner	The partner or other person in the firm who is a member of the Institute of Chartered Accountants of India and is in full time practice and is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.
Engagement quality control review	A process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
Engagement documentation	The record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "work-papers" are sometimes used).
Engagement quality control reviewer	A partner, other person (should be a member of the Institute of Chartered Accountants of India) in the firm, suitably qualified external person, or a team made up of such individuals, with sufficient and appropriate experience and authority to objectively evaluate, before the report is issued, the significant judgments the engagement team made and the conclusions they reached in formulating the report. However, in case the review is done by a team of individuals, such team should be headed by a member of the Institute.
Firm	A sole practitioner, partnership or corporation or other entity of professional accountants.
Partner	Any individual with authority to bind the firm with respect to the performance of a professional services engagement.
Professional standards	Engagement standards, as defined in the AASB's "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services," and relevant ethical requirements as contained in the Code. TY

Reasonable assurance	In the context of this SQC, a high, but not absolute, level of assurance.
Staff	Professionals, other than partners, including any experts the firm employs.
Complying, with relevant Requirements	The Partners and Staff within the firm are responsible for establishing and maintaining the system and applying its requirements properly.

➢ Elements of the System of Quality Control:

Leadership Responsibilities for Quality within the Framework	Establish Policies & Procedures to ¬ Design an internal culture recognising Quality control. ¬ Firm's chief executive officer or, managing board of partners to assume ultimate responsibility for Quality Control ¬ Person assigned has sufficient and appropriate experience and ability to adhere the responsibility. ¬Internal Culture recognising Quality Control includes compliances with Professional Standards, Legal Compliances and Laws and Regulations.
Relevant Ethical Requirement	t Establish Policies and procedures designed to provide that the firm and its personnel comply with relevant ethical requirements of. (a) Integrity; (b) Objectivity; (c) Professional competence and due care; (d) Confidentiality; and (e) Professional behaviour.
Independence	Establish Policies and procedures designed to maintain independence to ¬ Communicate its requirements to the Management. ¬ Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action against them. ¬ Resolutions on Breach of Independence. ¬ Written confirmation of compliance with its policies and procedures on independence from all firm personnel.
Acceptance and Continuance of Client Relationships and Specific Engagements	Establish Policies and procedures for the acceptance/ continuance and withdrawal of client relationships and specific engagements, designed to provide the ¬ Firm is Competent to perform the engagement. ¬ Has the capabilities, including time and resources, ethical values ¬ Client integrity is available.
Human Resources & Engagement Performance	Establish Policies and Procedures designed to provide and assign sufficient personnel with the ¬ competence, capabilities, and commitment to perform engagements with professional standards and ¬ to issue reports that are appropriate in the circumstances.

Monitoring	Establish policies and procedures for Monitoring. ¬ Firm's Quality Control Policies and Procedures ¬ Evaluating, Communicating and Remedying Identified Deficiencies ¬ Complaints and Allegations
Documentation of the System of Quality Control	Establish policies and procedures requiring appropriate documentation for ¬ Evidence of the operation of each element of its system. ¬Retention for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation. ¬ Complaints and allegations and the responses to them. Depending upon the size of the firm and number of office and nature and complexity of the firm. Large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods in the documentation such as manual notes, checklists and forms.

3.9 DEVELOPMENT OF INTERNATIONAL STANDARDS ON AUDITING:

The explosive growth of investing and raising capital in the global markets has put new emphasis on the development of international accounting, auditing, and ethical standards. The worldwide accountancy profession, together with preparers, users, regulators, and other bodies, have been exerting great effort in the development of high-quality standards that can be implemented in the global as well as the domestic capital markets. The harmonization of these standards is receiving greater and greater attention by the participants in these markets.

International standards on auditing are promulgated by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants. A codified core set of international standards on auditing were completed and released in 1994. The release of the core set has led to a growing acceptance of the standards by national standards setters and auditors involved in global reporting and cross-border financing transactions. In addition, the growth of assurance services has led to the development of a new framework and a new direction for the work of the IAPC.

The benefits for the use of common global accounting standards by preparers of financial statements and common auditing standards by auditors of those statements have been debated for a number of years. Although the debate continues, there is strong support for the creation of a common set of standards for use in capital markets around the world, particularly for cross-border financing transactions.

Two important sets of standards have emerged as candidates for widespread adoption: the accounting standards being developed by the International Accounting Standards

Committee (IASC) and the auditing standards being developed by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC).
Many global 1000 companies headquartered outside the United States are preparing their financial statements in accordance with international accounting standards and are having them audited in accordance with the international standards on auditing. These financial statements are being sent around the world to be used by investors and other interested parties, and for capital formation.

With various developments under way in the move toward greater harmonization of these standards for global reporting, cross-border financing, and national use, there is no doubt that the number of companies using them will grow from hundreds to thousands.
International standards should be of interest to accounting professionals for a number of reasons, including the following:

- Americans invest in foreign companies that use these standards. At present, this ownership is more than $500 billion and growing.
- Subsidiaries of foreign companies in the United States are using these standards. Foreign companies who start to report on a global basis will ask local management and auditors in the United States, as well as in other countries, to prepare and audit the financial statements using international accounting and auditing standards.

International Standards on Auditing

The International Standards on Auditing (ISA) have come a long way since the start of their development in the late 1970s. They started as guidelines under the harmonization process of IFAC and its member bodies. The AICPA is one of the founding member bodies of IFAC and has participated in its activities since inception. IFAC's main focus is the enhancement and further development of the worldwide accountancy profession through its activities in ethics, education, the public sector, management accountancy, technology, and auditing. The IAPC has been charged with the responsibility to enhance and expand the worldwide use of auditing standards. Its objective is to improve the quality and uniformity of international practice by--

- issuing international standards on auditing;
- issuing guidance on the application of such standards;
- promoting the adoption of the committee's pronouncements as the primary source of national standards and as guidance in cross-border offerings;
- promoting the endorsement of the standards by legislators and securities exchanges; and
- promoting debate with practitioners, users, and regulators throughout the world to identify user needs for new standards and guidance.

The IAPC receives public interest input through the Consultative Advisory Group (CAG), whose membership includes many of the leading international organizations of the world. CAG's purpose is to provide advice to the IAPC on its agenda; on issues of importance to the national, regional, and world communities; on new issues or revisions of existing material; on matters of public interest in the development of auditing standards; and on other practice guidance.

The IAPC issued 29 international auditing practice guidelines through 1990. At that time, it became clear that global capital markets needed auditing standards for cross-border financing. When the IFAC membership endorsed a change from guidelines to standards, the IAPC started on a lengthy comprehensive project to revise the guidelines and codify international auditing standards. In 1994, the IAPC issued a comprehensive, common body of international standards on auditing (ISAs), primarily focused on the audit of financial statements.

Growing Acceptance of the ISAs

Since their release, there has been a growing acceptance of ISAs, particularly adoption and use of the standards by:

- A number of the large international accounting firms as the basis for their worldwide auditing standards;
- Global public companies reporting outside their national borders;
- Companies involved in issuing securities in cross-border financing transactions;
- Companies issuing securities in domestic financing transactions;
- Regulatory bodies accepting financial statements audited using the ISAs for regulatory filings in their countries, or requiring the use of ISAs by including them in company law;
- Global organizations, such as the Organization for Economic Cooperation and Development, that have endorsed ISAs for use in auditing financial statements in their jurisdictions; and
- National accountancy bodies that have used ISAs as the basis for their national auditing standards.

A 1998 survey of IFAC member bodies revealed some interesting information. First of all, of the 65 countries responding, the survey showed that eighteen (18) countries have completely adopted the ISAs as their national auditing standards. Of the remaining 47 countries, the survey showed that:

- 28 countries had no significant differences between the national standards and the ISAs;
- 9 countries had some significant differences, usually relating to reporting; and
- 10 countries had not identified whether there were any differences.

At the time the codification was released, a number of standards setting bodies and other organizations around the world indicated that they would take substantial steps to harmonize with the ISAs, and to further consider the use of ISAs. Among these are the following:

- **The Netherlands:** The Netherlands Auditing Standards Board decided to forgo the further development of national auditing standards and adopted the ISAs instead. Local requirements are presented at the end of each individual standard. Dutch auditing standards are published in both English and Dutch.
- **The United Kingdom:** At the same time the IAPC was developing the codification of the ISAs, the auditing practices board of the United Kingdom was revising its national standards. The U.K. auditing practices board based its standards on the ISAs but used different wording and added local requirements. Each individual standard has a compliance statement at the end relating to whether compliance with the U.K. standard will also comply with the corresponding ISA.
- **South Africa**: A project is in process to harmonize the South African Standards with the ISAs.
- **European Commission:** The European Commission conducted a study that resulted in the publication of a green paper, "The Role, The Position, and the Liability of the Statutory Auditor within the European Union," in 1996. It was followed later in the year by a major conference on the topic. In a summary of the conference's

conclusions, a spokesman indicated that there appears to be substantial use of ISAs in many member countries. The Commission decided to obtain more information on this use, with the intent of considering the ISAs as the standards for use in the member countries. The Fédération des Expert Comptables Européens (FEE), the regional organization representing the accounting profession in EU, agreed to assist.

- **Fédération des Expert Comptables Européens:** In the study and report by the FEE, "Setting the Standards: Statutory Audit in Europe," President David Darbyshire said that "FEE demonstrates the success of this process and the progress made in Europe in applying international standards on auditing. Convergence in country practice, as regards audit approach, is a reality." The executive summary stated that in part "Auditing standards in the countries of Europe are set at the national level by individual country standards setters ... The national standards setters in Europe all look towards ISAs in setting their local standards ... The study indicates a high degree of correlation between national standards and ISAs, either in terms of existing national standards or draft standards due for implementation nationally in the foreseeable future."

Other jurisdictions are also pursuing harmonization of accounting and auditing standards.

- **Canada:** In a 1997 interim task force report on the development of strategies for the direction of standards setting, the Canadian Institute of Chartered Accountants (CICA) concluded as follows: "The ultimate goal is a body of auditing standards accepted internationally and by capital markets worldwide. Canada will play a significant role on a standard-setting body based either internationally or in North America." The final report, released August 27, 1998, recommended that "Canada should endorse the principle of the internationalization of standards setting for private sector accounting and auditing." The report went on to say, "CICA should continue to play a leadership role in setting auditing standards for the foreseeable future. ... This recommendation means that CICA should find the resources internally to reaffirm Canada's significant role in establishing international auditing standards, while maintaining its full responsibility for setting those standards in Canada."
- **The United States:** The AICPA has started to increase its focus on international standards. The AICPA board established an International Strategy Special Committee, chaired by a former AICPA chair, Tom Rimerman, to develop a strategy, initiatives, and an action plan to elevate the AICPA's consideration of, and influence on, international processes in the areas of accounting, auditing, and ethics. The AICPA's Auditing Standards Board (ASB) considered these initiatives and established a number of action plans to implement key initiatives, as set forth in its report "Horizons for the Auditing Standards Board." Some of these action plans include establishing a standing subcommittee of the ASB on international auditing standards, promoting opportunities for joint projects, and initiating an effort for reporting on the credibility of information.

The International Organization of Securities Commissions (IOSCO) and the IAPC have opened discussions to consider the possible endorsement of the international standards on auditing.

Independence, Ethics and Enforcement at the National Level

The ultimate acceptance by users of financial statements for both the international standards on auditing and the international accounting standards will largely be attributable to the proper application of these standards by accountants and auditors.

In the same way that the IAPC changed from a guidelines committee to a standards setter, the International Federation of Accountants is also changing. In the past, IFAC has issued its code of ethics and related pronouncements with the understanding that the member bodies will make their best efforts to adopt them. IFAC is now considering the possibility of a new program to review its entire code of ethics with the aim of establishing a member body program of adoption of its ethics, independence, education, peer review, and enforcement pronouncements.

This program, if it can be implemented and adopted by the IFAC member bodies, would be a significant factor in providing additional credibility to the application of the international accounting and auditing standards.

The Growing Global Capital Markets

In addition to the very significant accounting and auditing harmonization developments, there are a number of other changes in the global marketplace that are having an important impact on the future direction of the work of the IAPC, most notably the astounding growth of the global capital markets. The increase in market value of all publicly traded companies and the notional value of derivative securities are clear indicators of the emerging global economic and business environment.

In 1987, the global equity markets capitalization stood at U.S. $8 trillion; by June 30, 1999, it had almost quadrupled to U.S. $30.2 trillion. The use of derivative securities is also growing at an explosive pace--current estimates are in the area of $40 trillion.

The audit of financial statements is one of the key statutory requirements of regulators around the world. It is clear that the audit will remain vital for the stability and credibility of capital markets.

The IAPC has a responsibility to develop the best and most advanced set of auditing standards that meet the interests of the profession and the public. The IAPC is committed to the development of high quality auditing standards and supplemental guidance to achieve that end.

Recent IAPC Activities

The following are some of the recent standards and statements issued, under development, out for exposure, or that are presently on the IAPC project list:

- **A Revised ISA on Going Concern:** This standard will link to a new international accounting standard that sets up management assessment and disclosure requirements for going concern. This new accounting standard requires not only a specific management assessment of going concern, but also requires accounting disclosure when events and circumstances indicate a significant uncertainty that may affect on the going concern assumption. The new auditing standard builds on the accounting requirements, specifies the audit requirements with respect to them, and extends the other auditor requirements with respect to going concern.

- **A Revised ISA on Fraud:** The IAPC has studied the present environment with respect to financial statement fraud and has examined the research and new standards issued recently by other bodies on this topic. A revised ISA is under development.

- **A New International Audit Practice Statement (IAPS) on Environmental Matters in an Audit:** While the basic audit standards include requirements with respect to accruals and disclosures of matters affecting financial statements, the new IAPS will discuss the auditor considerations when applying the basic audit standards to environmental matters.

- **A New ISA on Communications to Those Charged with Governance:** Auditors have long been involved in various aspects of corporate governance. This new ISA prescribes the communication of audit matters of governance interest and describes the various matters that auditors should discuss with persons responsible for governance in an entity.

- **A New IAPS on the Year 2000 Issue: An** international audit risk alert on this topic was issued in December 1997, and an IAPS in July 1998.

The Growing Information Needs of Users

While there are many changes in this area, three are most important. They are the information needs arising from:

- The global information technology and communications revolution,
- The global expansion of business, and
- The global information and knowledge flow.

These three changes are not just increasing the need for information but also for its reliability. Most importantly, this information is not just financial in nature, but also relates to a broad range of other areas.

It is clear to the IAPC that the current financial statement audit model the current basis of the ISAs does not fit the new information needs of users. The solution was the development of a new framework described in a proposed international standard on "Assurance Engagements."

Part of the solution was to broaden the definition of information to include

- Nonfinancial information,
- Process and performance information,
- Qualitative information, and
- Database information.

The framework includes a set of general principles for engagements meeting the criteria of an assurance services engagement. The general principles are intended to be used by auditing standards setters, such as the IAPC, in developing new assurance services standards, or by engagement personnel when a standard has not yet been developed for an assurance service.

New Services of the Accountancy Profession to Meet Those Needs

The accountancy profession does not stand still when it sees new market opportunities. What are the opportunities for new services for the accountancy profession, and what does the IAPC have to do in developing new standards to cover them? Some examples that relate to the new assurance services framework are as follows:

- Expanded reporting on financial information by directors and management, such as management's discussion and analysis (e.g., the U.S. SEC requirement for public companies);

- Reporting on nonfinancial information by directors, such as directors' reports to shareholders on corporate governance (e.g., the reports required by the London Stock Exchange);
- Reporting on the results of processes by directors and management, such as directors' reports on the adequacy of internal controls (e.g., the reporting required by the banking industry in a number of countries);
- Reporting on compliance with laws and regulations (e.g., the oxygen content in gasoline required in the U.S.);
- Reporting on qualitative information by directors, such as ethical guidelines (e.g., the government contract industry guidelines on ethical conduct); and
- Reporting on database information, such as the reliability of data warehouse information (e.g., a company's customer information database).
- In order to address these new information needs, the IAPC is refocusing its efforts to devote some of its resources to the development of standards and statements in areas such as:
  - Reporting on internal control,
  - Reporting on compliance with laws and regulations,
  - Reporting on statements of corporate governance, and
  - Prospective financial information (revision of a current ISA).

The Future

A number of additional steps must be taken by the worldwide accountancy profession and by the global business leaders. Foremost is a set of global independence, ethics, and enforcement requirements, and a set of global corporate governance rules.

IFAC can play an important part in this implementation by requiring each member body to take such action, rather than merely encouraging implementation. Such a set of rules will not only help to improve the implementation of auditing (and accounting) standards, but will also help to reduce the expectation gap in performing audits of financial statements.

Global business leaders must implement a base set of corporate governance rules. These rules should apply, at a minimum, to any company involved in a cross-border financing transaction and to any company listing its securities on securities exchanges outside of its national borders. At the present time, these companies may only be subject to national corporate governance rules or specific rules set forth by certain listing agencies or securities commissions. A set of global corporate governance rules will not only help to improve the ethics of businesses but will also reduce the expectation gap in auditing financial statements prepared under those rules.

With these rules functioning on a global basis, with a strong set of globally acceptable and transparent international accounting and auditing standards, the accountancy profession can continue to play a key role in the global capital markets and the burgeoning assurance service markets.

3.10 ROLE OF AASB OF INDIA

The credibility of financial statements and other types of information is significantly enhanced when it is audited or reviewed by independent public accountants. In turn, the quality of the work performed by the public accountants is reflective of the strength and clarity of auditing and assurance standards on which this work is based. The primary role of the Auditing and Assurance Standards Board (AASB) is to develop such standards in the public interest.

The responsibilities of the AASB include the following:

1. Developing and maintaining high-quality auditing, other assurance and related services standards, for both the private and public sectors, to respond to emerging needs of decision makers and assurance providers;
2. Ensuring that a rigorous due process is followed in developing auditing, other assurance and related services standards, including providing opportunities for input by all those affected by the standards;
3. Communicating effectively with those affected by, and interested in, auditing, other assurance and related services standards; and
4. Using its volunteer, staff and financial resources efficiently, effectively and economically.

3.11 QUESTIONS

Short Answer Questions

1. Write short notes on accounting and auditing standards.
2. Write about assurance standards.
3. Write the statements
4. Write about the key aspects of the Standard on Auditing.
5. Short notes on IAPC

Essay Questions

1. Explain about Guidance notes.
2. Explain the development of international standards on auditing.
3. Write about the role of AASB of India.
4. Differentiate accounting and auditing standards
5. write about Public Company Accounting Oversight Board

3.12 REFERENCES

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- **Dr.N.Srihari**

Lesson - 4

AUDITINGAND ASSURANCE STANDARD BOARD IN INDIA

OBJECTIVES:

The objectives of this lesson are:

- To review the Functions of AASB
- To know the Procedure for issuing standards
- To know the Structure of SAs
- To Establishing high quality auditing standards and guidance for financial statement audits
- To review the existing and emerging auditing practices

STRUCTURE

4.1 Introduction
4.2 Compliance with auditing standards
4.3 Objectives of the auditing and assurance standards board
4.4 Procedure for issuing standards
4.5 Functions of AASB
4.6 Scope of SAs
4.7 Structure of SAs
4.8 List of standards on quality control, auditing, other assurance and related services
4.9 Self Assessment Questions
4.10 References

4.1 INTRODUCTION

In India, Auditing and Assurance standards are issued by ICAI. Auditing practices committee (APC)is established by the ICAI in 1982 to creates the standards on auditing practices. In the year 2002, the Auditing practices committee (APC) converted into Auditing and Assurance Standard Board (AASB) to prepare auditing standards independently. Accordingly, AASB issues Statements on Standard Auditing Practices and, Auditing and assurance Standards under the authority of the Council.

As per section 143 (10) of the Companies Act, 2013, The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

4.2 COMPLIANCEWITHAUDITINGSTANDARDS

As per section 143 (9) of the Companies Act, 2013, every auditor shall comply with the auditing standards.

If for any reason the member is unable to perform an audit in accordance with the generally accepted auditing standards, his report should draw attention to any material departures there from, failing which he would be held guilty of professional misconduct under clause 9 of Part 1 of the Second Schedule to the Chartered Accountants Act, 1949.

4.3 OBJECTIVES OF THE AUDITING AND ASSURANCE STANDARDS BOARD (AASB)

The following are the objectives of the Auditing and Assurance Standards Board (AASB):

1. To review the existing and emerging auditing practices worldwide and identify areas in which Standards on Quality Control, Engagement Standards and Statement on Auditing need to be developed.
2. To formulate Engagement Standards, Standards on Quality Control and Statement on Auditing so that these may be issued under the authority of the Council of the Institute.
3. To review the existing Standards and Statements on Auditing to assess their relevance in the changed conditions and to undertake their revision, if necessary.
4. To develop guidance notes on issues arising out of any Standard, auditing issues pertaining to any specific industry or on generic issues, so that those may be issued under the authority of the Council of the Institute.
5. To review the existing Guidance Notes to access the irrelevance in the changed circumstances and to undertake their revision, if necessary.
6. To formulate General Clarifications, where necessary, on issues arising from Standards.
7. To formulate and issue Technical Guides, Practice Manuals, Studies and other papers under its own authority for guidance of professional accountants in the cases felt appropriate by the Board.

4.4 PROCEDURE FOR ISSUING STANDARDS

Auditing and Assurance Standards Board (AASB) of the Institute formulates the auditing standards. Broadly, the following procedure is adopted for the formulation of Standards on Auditing (SAs):

- The Auditing and Assurance Standards Board identifies the areas where auditing standards need to be formulated and the priority in regard to their selection.
- In the preparation of Auditing Standards, AASB is assisted by study groups/task force constitute to consider specific project. Study group comprising of a cross section of members of the Institute.
- The study group / taskforce is responsible for preparing the primarily draft of Standards.
- Based on the work of the study groups, an exposure draft of the proposed Standards is prepared by the Committee and issued for comments by members of the ICAI.
- After taking the comments into consideration, AASB finalize the draft and submit to the Council of the Institute.
- The Council on its review of the draft, makes suitable modifications in consultations with the AASB and then Standards / Statements is issued under the authority of the Council.

While formulating the auditing standards, the Board also takes into consideration International Standards on Auditing (ISA) issued by the International Auditing Practices Committee (IAPC), applicable awes, customs, usages and business environment in the India.

4.5 FUNCTIONS OF AASB

The main function of the AASB is to review the existing auditing practices in India and to develop Statements on Standards on Auditing (SAs) so that these may be issued by the Council of the Institute. While formulating the SAs, the AASB takes into consideration the ISAs issued by the IAPC, applicable laws, customs, usages and business environment in India. The SAs are issued under the authority of the Council of the Institute. The AASB also issues Guidance Notes on the issues arising from the SAs wherever necessary. The AASB has also been entrusted with the responsibility to review the SAs at periodical intervals.

4.6 SCOPE OF SAs

The SAs apply whenever an independent audit is carried out; that is, in the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion. The SAs may also have application, as appropriate, to other related functions of auditors. Any limitation on the applicability of a specific SA is made clear in the introductory paragraph of the SA.

4.7 STRUCTURE OF SAs:

SAs are structured in the particular manner:

- Introduction: It includes the purpose, scope, and subject matter as well as the responsibilities of the auditor and others in that context.
- Objective: It includes the objective of the auditor in the audit area addressed by that particular SA.
- Definitions: For higher understanding of the SAs, pertinent terms are delineated in each SA.
- Requirements: Every objective is shored up by clearly stated requirements. Requirements are always expressed by the phrase “the auditor shall.”
- Application and Other Explanatory Material: The application and other explanatory material explains more exactly what is meant by a requirement or is intended to cover, or includes examples of procedures that can be appropriate under certain circumstances.

4.8 LIST OF STANDARDS ON QUALITY CONTROL, AUDITING, OTHER ASSURANCE AND RELATED SERVICES:

ICAI has issued 43 Engagement and Quality Control Standards (formerly known as Auditing and Assurance Standards) covering various topics relating to auditing and other engagements. All Chartered Accountants in India are required to adhere to all these standards. If a Chartered Accountant is found not to follow the said standards he is deemed guilty of professional misconduct. These standards are fully compatible with the International Standards on Auditing (ISA) issued by the IAASB of the IFAC except for two standards SA600 and SA 299, where corresponding provisions do not exist in ISA.

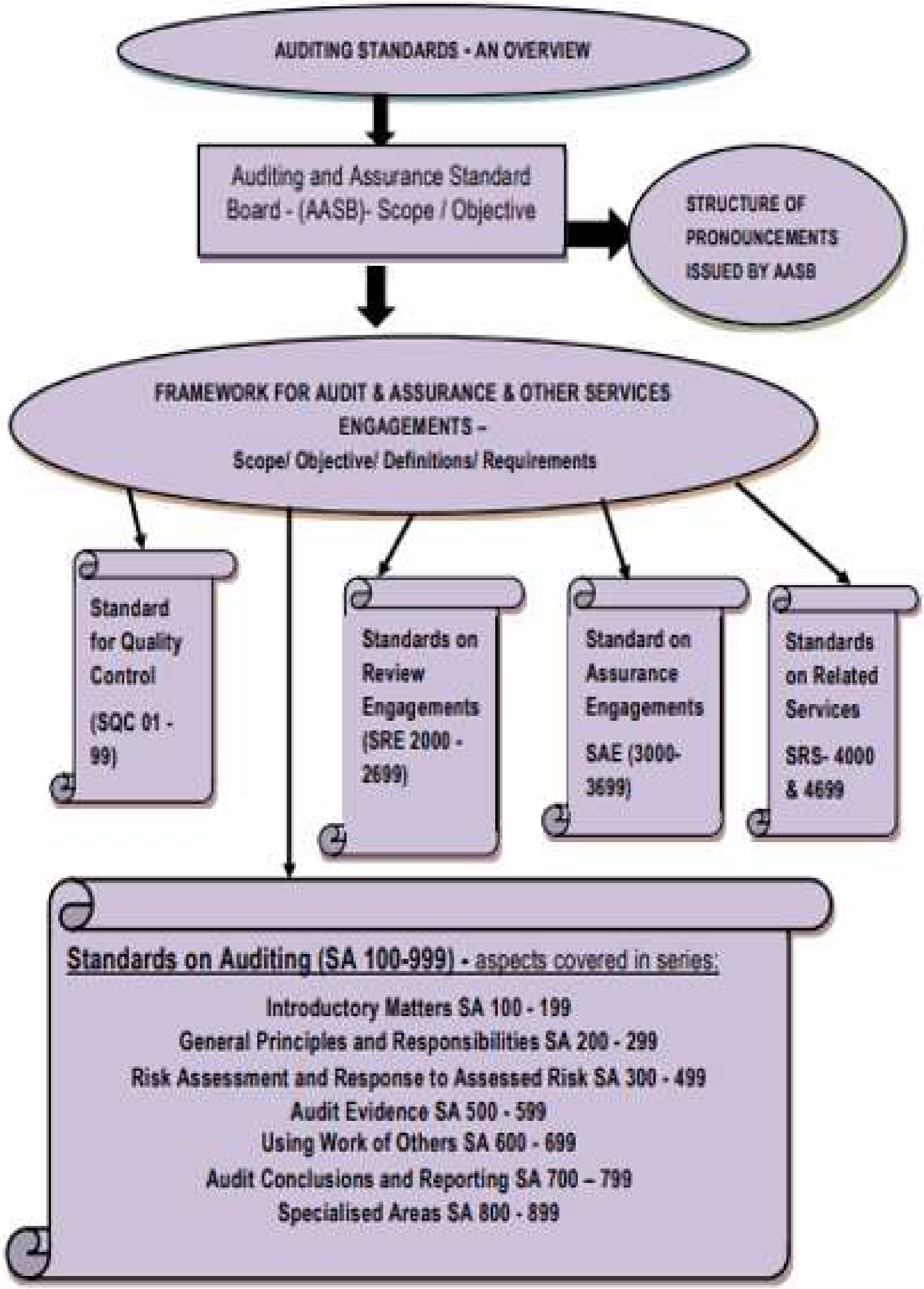
The following Standards issued by the Auditing and Assurance Standards Board under the authority of the Council are collectively known as the Engagement Standards:

a. Standards on Auditing (SAs) – to be applied in the audit of historical financial information.
b. Standards on Review Engagements (SREs) - to be applied in the review of historical

financial information.

c. Standards on Assurance Engagements (SAEs) - to be applied in assurance engagements, other than audits and reviews of historical financial information.

d. Standards on Related Services (SRSs) - to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.



SA-No.	Name of Standard on Auditing	Practical Approach
SA-200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.	We should see to it that all the relevant laws, standards and regulations relating tothat company are getting complied while preparation of financial statements. The audit evidence for the same are to be collected and documented. None of the audit procedures applied should hamper the independence of the auditor.
SA-210	Agreeing the Terms of Audit Engagements	The auditor before the start of the audit should collect engagement letter from the management which clearly specifies the scope of the audit and describes clearly the management's responsibility and the auditor's responsibility.
SA-220	Quality Control for an Audit of Financial Statements	The engagement leader should keep control on the overall performance of audit. The leader should see to it that the professional ethics and standards are being taken care of and points covered in 'Standards on quality control (SQCs)' are getting covered while conducting audit.
SA-230	Audit Documentation	Documentation of each audit procedure conducted and the audit working papers provided by the client should be maintained either in hard or soft form.
SA-240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	It is expected that the auditor should use professional skepticism in conduct of audit. This means he should not blindly accept whatever information is provided by the management. The auditor for assurance should obtain a management representation letter. If any kind of fraud is identified during the audit it should be reported.
SA-250	Consideration of Laws and Regulations in an Audit of Financial Statements	The auditor can verify the measures that are being taken by the staff of the entity under review for complying with the relevant laws & regulations. The internal controls of the entity can also be verified so as to ensure the check points relating to such applicable laws.

SA-260	Communication with Those Charged with Governance	The auditor should see to it that all audit observations which require attention of the top management should be communicated to them.
SA-265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	The deficiencies noticed in IFC testing should be informed to the higher authorities of the entity as well as to those who are actually involved in carrying out that particular process.
SA-299	Responsibility of Joint Auditors	In case of joint audit, we need to properly communicate about the scope of work of each joint auditor. There should be proper communication and reliance on each of the auditor's work. Joint responsibility allocation should be signed and confirmed by each of the joint auditors.
SA-300	Planning an Audit of Financial Statements	All the details relating to the business under audit should be taken into consideration and the audit plan should be developed accordingly. The audit plan should be documented.
SA-315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment	The auditor should after gaining the knowledge of the business and having a discussion with the management of the organization under review should set the materiality level for the purpose of the audit assignment. This involves assessing the probable areas where there are chances of occurrence of errors.
SA-320	Materiality in Planning and Performing an Audit	The auditor should for the purpose of the audit assignment decide what can be the material transactions for the entity. This may include deciding the value and volume of vouchers that are to be vouched. Deciding which transactions can be ignored or should be given high weightage.
SA-330	The Risks Auditor's Responses to Assessed	On the basis of the risks identified as per SA 315, the auditor should decide on what way it should be presented in the report. To inform the team about the risks identified and the course of action to be taken on the same.

SA-402	Audit Considerations Relating to an Entity Using a Service Organization	This SA is applicable where the organisation under review is using the services of other organisations for such items those are having an impact on the financial statements of that entity.
SA-450	Evaluation of Misstatements Identified during the Audit	If any kinds of errors are identified in the financial statements during the audit then proper call should be taken regarding the same on the basis of the materiality of the amount which is misstated. The misstatements so identified are to be reported to the higher authorities.
SA-500	Audit Evidence	The audit evidence obtained should form the basis of the points reported in the financial statements and the audit report.
SA-501	Audit Evidence-Specific Considerations for Selected Items	This SA is applicable for the specific considerations like inventory when it is material from the prospective of financials, litigations and claims involving the entity and presentation and disclosure of segment information.
SA-505	External Confirmations	This SA is to be considered when the auditor is obtaining external confirmations as audit evidence. The design and performance of such procedures is mentioned in the standard.
SA-510	Initial Audit Engagements-Opening Balances	As per this SA when we are doing the audit for the first time, we need to verify whether the financials and the accounting policies mentioned are not contradicting each other. While starting the audit of a new financial year we are supposed to verify the opening balances.
SA-520	Analytical Procedures	Financial analytical procedures include use of ratios, analysing prior period items, checking relevance of budgets and forecasts, etc.
SA-530	Audit Sampling	Audit sampling is dependent on the materiality level set while doing the audit of a particular organisation. Sampling refers to the selecting data for the purpose of vouching & verification.
SA-540	Auditing Accounting Estimates,	This SA is to be referred when there is use of

	Including Fair Value Accounting Estimates, and Related Disclosures	accounting estimates in the preparation of financial statements. The auditor's responsibilities relating to the same are stated in this SA.
SA-550	Related Parties	Firstly, the related parties of the entity are to be identified. Then the transactions pertaining to them are to be identified and reported as per the accounting standard.
SA-560	Subsequent Events	The events occurring after the balance sheet date are to be identified and appropriate actions and reporting is to be done accordingly.
SA-570	Going Concern	We need to identify if there are any items which have occurred that affect the continuity of the business. If so the same have to be reported.
SA-580	Written Representations	The written representation is a kind of confirmation obtained from the management regarding the overall transactions of the entity. This SA is to be considered for the preparation of written representation.
SA-600	Using the Work of Another Auditor	This SA is regarding the approach of the engagement leader as well as the engagement partner when he is using and relying on the work done by his subordinate or another auditor.
SA-610	Using the Work of Internal Auditors	This SA is relevant when the statutory auditor is using the work of internal auditor for the purpose of the audit.
SA-620	Using The Work of An Auditor's Expert	This SA becomes relevant when the expertise of other party is to be used and obtained for the purpose of obtaining audit evidence.
SA-700	Forming an Opinion and Reporting on Financial Statements	The auditor can give the following types of opinion: 1) Unqualified opinion 2) Qualified opinion 3) Modified opinion 4) Disclaimer of opinion This SA is to be referred while giving any of the opinion mentioned above.
SA-701	Communicating Key	The points that are mentioned in the audit

	Audit matters in the Independent Auditor's report	report are to be discussed with the auditee's top management and their respective staff.
SA-705	Modifications to the Opinion in the Independent Auditor's Report	When the auditor feels that modification of the opinion given in the previous report is required, then this SA becomes relevant and is to be referred.
SA-706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report	When there are circumstances when qualified or disclaimer of opinion is not required but emphasis is to be given on certain items then emphasis on matter paragraph is used while reporting. This SA then becomes relevant in such circumstances.
SA-710	Comparative Information-Corresponding Figures and Comparative Financial Statements	When conducting the audit of current financial year, we are supposed to report the figures of the previous financial year as well so we need to check those figures as well whether those are true and correct.
SA-720	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements	This SA becomes applicable when there is any other information disclosed in the financial statements.
SA-800	Special Considerations – Audit of Financial Statements Prepared in Accordance with Special Purpose Frameworks	The special frameworks applicable to the entity are to be identified if any and the care is to be taken if those are correctly followed.
SA-805	Special Considerations – Audit of Single Financial Statements and specific Elements, Accounts or Items of a Financial Statements	This SA is relevant only when there are any such specific assignments as mentioned in this SA. The approach of the auditor pertaining to the same is mentioned in this SA.
SA-810	Engagements to report on Summary Financial Statements	This SA is relevant when the auditor is conducting the audit of summary financial statements which are less detailed than the normal financials.

Sre- no.	Name of Standard on review engagement	Description
Sre-2400	Engagements To Review Financial Statements	The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the practitioner's professional responsibilities when a practitioner, who is not the auditor of an entity, undertakes an engagement to review financial statements and on the form and content of the report that the practitioner issues in connection with such a review. The objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner's attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework (negative assurance).
Sre-2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity	The purpose of this Standard on Review Engagements (SRE) is to establish standards and provide guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client, and on the form and content of the report. The term "auditor" is used throughout this SRE, not because the auditor is performing an audit function but because the scope of this SRE is limited to a review of interim financial information performed by the independent auditor of the financial statements of the entity.

SAe- no.	Name of Standard on Assurance engagement	Description
SAE-3400	The Examination of Prospective Financial Information	As per this SAE the term prospective financial information means statements prepared on the basis of future assumptions and best judgment estimates of the management. The auditor has to verify whether the assumptions made by management are reasonable and consistent with the purpose of the information required. The auditor should see to it that the estimates and assumptions used are properly disclosed by the management.
SAE-3402	Assurance Reports on Controls At A Service Organisation	This Standard on Assurance Engagements (SAE) deals with assurance engagements undertaken by a professional accountant in public practice to provide a report for use by user entities and their auditors on the controls at a service organization that provides a service to user entities that is likely to be relevant to user entities' internal control as it relates to financial reporting.
SAE-3420	Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus	The objectives of the practitioner are: (a) To obtain reasonable assurance about whether the pro forma financial information has been compiled, in all material respects, by the responsible party on the basis of the applicable criteria; and (b) To report in accordance with the practitioner's findings.

SrS- no.	Name of Standard on related Service	Description
SRS-4400	Engagements to Perform Agreed Upon Procedures Regarding Financial Information	The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.
SRS-4410	Engagements to Compile Financial Information	This Standard on Related Services (SRS) deals with the practitioner's responsibilities when engaged to assist management with the preparation and presentation of historical

		financial information without obtaining any assurance on that information, and to report on the engagement.

4.9 QUESTIONS

Short Answer Questions:

1. Write short notes on auditing standards.
2. Write about AASBI.
3. Write the objectives of the auditing and assurance standards board
4. Write about the Scope of SAs
5. Structure of SAs

Essay Questions

1. Explain about AASBI.
2. Explain the procedure for issuing standards.
3. List out the Auditing and Assurance Standards board of India.

4.10 REFERENCES

1. https://resource.cdn.icai.org/67340bos54163-cp1.pdf
2. Advanced Auditing and Professional Ethics, PAPER 3, MODULE – 1, Board of Studies, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi 110 002, India.
3. https://www.icai.org/new_post.html?post_id=662
4. https://www.taxdose.com/objectives-and-functions-of-the-accounting-standards-board/

- **Dr. N.Srihari**

LESSON - 5

INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD

OBJECTIVES

The objectives of this lesson are:

- Raising awareness of the key elements of audit quality.
- Encouraging key stakeholders to explore ways to improve audit quality.
- To know about the International Auditing and Assurance Standards Board.
- To know about the International Standards-Setting Boards.

STRUCTURE

5.1 HISTORY OF IAASB

The International Auditing and Assurance Standards Board (IAASB) was founded in March 1978. It was previously known as the International Auditing Practices Committee (IAPC).The IAPC's initial work focused on three areas: object and scope of audits of financial statements, engagement letters, and general auditing guidelines. In 1991, the IAPC's guidelines were recodified as International Standards on Auditing (ISAs).

In 2001, a comprehensive review of the IAPC was undertaken, and in 2002, the IAPC was reconstituted as the International Auditing and Assurance Standards Board (IAASB). In 2003, IFAC approved a series of reforms designed, among other things, to further strengthen its standard-setting processes, including those of the IAASB, so that they are responsive to the public interest.

In 2004, the IAASB began the Clarity Project, a comprehensive program to enhance the clarity of its ISAs. This program involved the application of new conventions to all ISAs, either as part of a substantive revision or through a limited redrafting to reflect the new conventions and matters of clarity generally.

5.1.1 PURPOSE

The mission of the International Federation of Accountants (IFAC), as set out in its constitution, is "to serve the public interest by contributing to the development, adoption and implementation of high-quality international standards and guidance; contributing to the development of strong professional accountancy organizations and accounting firms, and to high quality practices by professional accountants; promoting the value of professional accountants worldwide; and speaking out on public interest issues where the accountancy profession's expertise is most relevant." In pursuing this mission, the IFAC Board has established the International Auditing and Assurance Standards Board (IAASB) to function as an independent standard-setting body under the auspices of IFAC and subject to the oversight of the Public Interest Oversight Board (PIOB).

The IAASB develops and issues, in the public interest and under its own authority, high-quality auditing and assurance standards and other pronouncements for use around the world. The IFAC Board has determined that designation of the IAASB as the responsible body, under its own authority and within its stated terms of reference, best serves the public interest in achieving this aspect of its mission.

5.1.2 OBJECTIVE

The IAASB's objective is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

5.1.3 PRONOUNCEMENTS

In fulfilling the above objective, the IAASB develops and issues the following International Standards:

- International Standards on Auditing (ISAs) and International Standards on Review Engagements (ISREs) to be applied in audit and review engagements on historical financial information.
- International Standards on Assurance Engagements (ISAEs) to be applied in assurance engagements other than audits or reviews of historical financial information.
- International Standards on Related Services (ISRSs) to be applied in related services engagements.
- International Standards on Quality Control (ISQCs) to be applied for all services falling within the Engagement Standards of the IAASB.

The IAASB also publishes other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of professional auditors and assurance service providers.

The official text of the International Standards and other pronouncements is that published by the IAASB in the English language.

5.1.4 MEMBERSHIP

The members of the IAASB, including the Chair and Deputy Chair, are appointed by the IFAC Board on the recommendation of the Nominating Committee and with the approval of the PIOB. The appointment as Deputy Chair does not imply that the individual concerned is the Chair-elect.

The IAASB has 18 members comprising practitioners and non-practitioners, of whom no more than nine shall be practitioners and no less than three shall be public members. A public member is an individual who satisfies the requirements of a non-practitioner and is also expected to reflect, and is seen to reflect, the wider public interest. Not all non-practitioners are therefore eligible to be public members. The three public members may be members of IFAC Member Bodies.

The selection process is based on the principle of "the best person for the job," the primary criterion being the individual qualities and abilities of the nominee in relation to the position for which they are being nominated. However, the selection process also seeks a balance between the personal and professional qualifications of a nominee and representational needs, including gender balance, of the IAASB. Accordingly, consideration will be given to other factors including geographic representation, sector of the accountancy profession, size of organization, and level of economic development.

IAASB members may be accompanied at meetings by a technical advisor. A technical advisor has the privilege of the floor with the consent of the IAASB member he or she advises, and may participate in projects. Technical advisors are expected to possess the technical skills to participate, as appropriate, in IAASB debates and attend IAASB meetings regularly to maintain an understanding of current issues relevant to their role.

The IAASB may also include up to three observers, appointed at the discretion of the IFAC Board, in consultation with the PIOB. Observers may attend IAASB meetings, have the privilege of the floor, and may participate in projects. Observers are expected to possess the technical skills to participate fully in IAASB debates and attend IAASB meetings regularly to maintain an understanding of current issues.

The Chair of the IAASB Consultative Advisory Group (CAG) is expected to attend IAASB meetings, or to appoint a representative of a CAG member organization to attend. The Chair of the IAASB CAG, or appointed representative, has the privilege of the floor at IAASB meetings.

IAASB members are required to sign an annual statement declaring they will act in the public interest and with integrity in discharging their roles within IFAC. Nominating organizations of members of the IAASB are asked to sign independence declarations.

5.1.5 THE IAASB CHAIR

The IAASB Chair is an independently contracted position within IFAC. The Chair is selected by the Nominating Committee and recommended to the IFAC Board for its agreement and to the PIOB for subsequent approval. The provisions of the Chair's remuneration, benefits and other conditions are determined in a separate contract between the Chair and IFAC.

The IAASB Chair must agree to be bound by independence requirements in order to assume the position. The independence requirements are outlined in The Independence Requirements of the IAASB Chair.

5.1.6 TERMS OF OFFICE

The standard term for IAASB members is three years, with approximately one-third of the membership rotating each year. A member may serve up to two consecutive terms, for an aggregate term of six years.

The Chair ordinarily may serve three consecutive terms (as Chair or as a member for one to two terms preceding the appointment as Chair), for an aggregate of nine years. In exceptional circumstances, to be specified by the Nominating Committee, the Chair may serve for one additional consecutive term, for an aggregate term of twelve years.

5.1.7 MEETING PROCEDURES:

Each IAASB meeting requires the presence, in person or by simultaneous telecommunications link, of at least twelve appointed members.

IAASB meetings shall be chaired by the Chair or, in his/her absence, by the Deputy Chair. In the event of the absence of both, the members present shall select one of their number to take the chair for the duration of the meeting, or of the absence of the Chair and Deputy Chair.

Each member of the IAASB has one vote which can be exercised only by the appointed member. The affirmative vote of at least twelve of those present at a meeting in person or by simultaneous telecommunications link is required to approve or withdraw International Standards and to approve exposure drafts.

IAASB meetings to discuss the development, and to approve the issuance or withdrawal of International Standards, and to approve the issuance of exposure drafts and other pronouncements, are open to the public. Matters of a general administrative nature or with privacy implications may be dealt with in closed sessions of the IAASB; no decisions that would affect the content of the International Standards and other pronouncements issued by the IAASB are made in a closed session. Agenda papers for open sessions, including minutes of the meetings of the IAASB, are published on the IFAC website. The IAASB meetings and agenda papers are in English, which is the official working language of IFAC.

The PIOB has the right to attend, or be represented at, all meetings, including closed sessions, of the IAASB.

5.1.8 DUE PROCESS

The IAASB is required to be transparent in its activities, and in developing its International Standards, to adhere to due process as approved by the PIOB.

In setting its strategy and work program, the IAASB obtains the PIOB's conclusion as to whether the due process used to develop the IAASB's strategy and work program has been followed effectively and with proper regard for the public interest. The IAASB also obtains the PIOB's opinion, as at the date of that opinion, on the appropriateness of the items on the work program, and its approval of the completeness of the strategy and work program from a public interest perspective. The IAASB adds to its work program those items that the PIOB resolves should, from a public interest perspective, form part of the IAASB's work program.

5.1.9 CONSULTATIVE ADVISORY GROUP

The objective of the IAASB CAG is to provide input to and assist the IAASB through consultation with the CAG member organizations and their representatives at the CAG meetings, in order to obtain: advice on the IAASB's agenda and project timetable (work program), including project priorities; technical advice on projects; and advice on other matters of relevance to the activities of the IAASB.

5.1.10 OTHER

The IAASB cooperates with national standard setters to link their work with IAASB's own in preparing and issuing International Standards with an aim to share resources, minimize duplication of effort and reach consensus and convergence in standards at an early stage in their development. It also promotes the endorsement of the International Standards by national standard setters, legislators and securities exchanges and promotes debate with users, regulators and practitioners throughout the world to identify user needs for new International Standards and guidance.

The IAASB publishes an annual report, outlining its work program, activities and progress made in achieving its objectives during the year.

The IFAC Board will review the terms of reference of the IAASB at least every three years.

1. A non-practitioner is a person who is not a member or employee of an audit practice firm and, in respect of individuals who have been members or employees of such firms, there shall normally be a cooling-off period of three years, but that such period may, on a comply or explain basis, be reduced, provided that such a reduction shall not result in a cooling-off period of less than one year. Where an individual is proposed for appointment with less than a three year cooling-off period IFAC shall provide to the PIOB the reasons for the proposed appointment, which the PIOB shall, in line with its authority to approve all appointments to the IAASB, have the authority to accept or decline.

2. While these sentences reflect changes approved to membership in 2011, the transition to the changes in membership will commence in 2013.

5.2 THE PLANNING COMMITTEE

The Planning Committee is a standing committee of the International Auditing and Assurance Standards Board (IAASB).

The Planning Committee's objectives and responsibilities include:

- Developing the Strategy and Work Plan for Board consideration and approval;
- Monitoring the execution of the agreed Strategy and Work Plan, including the development of metrics for Board consideration;
- Proposing priorities, actions and related initiatives, in accordance with its charter and the agreed Strategy and Work Plan, for approval by the IAASB;
- Proposing changes to the IAASB's working procedures so that high-quality standards are developed and issued in the public interest in a transparent, efficient, and effective manner;-and
- Counselling and advising the IAASB Chair and Technical Director on matters and activities relating to achievement of the objectives of the IAASB.

The Planning Committee's purpose, objectives, responsibilities, and composition are set below.

5.2.1 IAASB PLANNING COMMITTEE CHARTER

5.2.1.1 Purpose:

1. The International Auditing and Assurance Standards Board (IAASB) Planning Committee (Planning Committee) is a standing committee of the IAASB. The purpose of the Planning Committee is to formulate views and advise the IAASB on matters of

strategic and operational importance to the IAASB, while also relieving the IAASB of the need to address certain administrative matters that do not necessarily require deliberation by the IAASB. In addition, the Planning Committee acts as counsel and advisor to the IAASB Chair and Technical Director on matters and activities relating to achievement of the objectives of the IAASB.

2. The Planning Committee reports to the IAASB.

5.2.1.2 Objectives:

The objectives of the Planning Committee are as follows:

- To identify and respond to strategic opportunities, threats and other developments in the environment in which audit, assurance and related services are performed, and in which standards for such services are set so that the work of the IAASB continues to be effective in protecting the public interest and strengthening public confidence in audit, assurance and related services engagements.
- To identify and respond to the need for change to IAASB's working procedures and practices so that they continue to support the development of high-quality standards in the public interest in a transparent, efficient and effective manner.
- To counsel and advise the IAASB Chair and Technical Director on matters and activities relating to achievement of the objectives of the IAASB.

5.2.1.3 Responsibilities

To achieve its objectives, and after appropriate consultation with the IAASB as it considers appropriate, the Planning Committee:

- Develops and, as necessary, revises the strategy, work plan and related initiatives of the IAASB in accordance with its stated terms of reference for approval by the IAASB.
- Monitors the effective execution of the Strategy and Work Plan.
- Provides guidance on the initiation of projects to be undertaken by the IAASB (including, as appropriate, recommending to the Board either that a project proposal be approved or that no new project be initiated).
- Provides guidance on, and recommends to the Board, changes to the IAASB's working procedures, as necessary, for the development and issuance of standards or other publications, in the public interest in a transparent, efficient and effective manner.
- Provides advice on task force or working group compositions.
- Reflects on and provides input or advice on the management and conduct of IAASB meetings to improve effectiveness.
- Approves on behalf of IAASB a Public Report outlining the IAASB work program, activities and progress made in achieving its objectives during the period under review.
- Addresses other matters at the request of the Public Interest Oversight Board (PIOB), the IAASB Consultative Advisory Group (CAG), or the IAASB.
- Monitors the effectiveness of liaison activities with other Standard Setting Boards.

The Planning Committee advises and supports the IAASB Chair and Technical Director in identifying and responding to other matters relating to achievement of the objectives of the IAASB, including but not limited to the execution of the IAASB standard-setting and related activities, the Board's policies, processes and procedures, and the IAASB's liaison arrangements and engagement with stakeholders.

The Chair of the Planning Committee provides feedback to the IAASB on matters discussed by the Planning Committee.

5.2.1.4 Composition:

- The Planning Committee is chaired by the IAASB Chair.
- The Planning Committee comprises four to six members of the IAASB and the IAASB Technical Director. Planning Committee members are not ordinarily accompanied at meetings by a technical advisor.
- Members of the Planning Committee are appointed by the IAASB Chair. The IAASB Chair has discretion to change IAASB members that serve on the Planning Committee at any point in time, which may include providing for the rotation of IAASB members. The Chair of the Planning Committee provides feedback to the IAASB on changes to Planning Committee members within a reasonable time after a change(s) and confirms the members of the Planning Committee at least annually.
- The IAASB CAG may appoint one of its members as an observer to the Planning Committee.
- The Chair of the Planning Committee may invite other persons to attend Planning Committee meetings as observers (for example, the Chair of a task force and project staff may be invited if issues related to that project are to be discussed). The Managing Director Professional Standards and IAASB Senior Staff are ordinarily also invited to attend Planning Committee meetings.
- A member of the IAASB's staff provides administrative and technical support to the Planning Committee.

5.2.1.5 Other

- The Planning Committee will engage or interact through written communication or will meet in-person or via video- or teleconference to discharge its responsibilities, as directed by the Chair of the Planning Committee or by the Technical Director, in consultation with the Chair of the Planning Committee.
- The membership and charter of the Planning Committee are to be posted on the IAASB website.
- The charter of the Planning Committee is to be reviewed by the IAASB from time to time, as deemed necessary.

JURISDICTIONAL/NATIONAL AUDITING STANDARD SETTERS (NASS):

Annually, the IAASB hosts a meeting of a group of jurisdictional/national auditing standard setters (NASS) from around the world that share the common goals of promulgating high-quality standards, and reaching consensus at an early stage in their development. The Statement of Purpose of IAASB and National Auditing Standard Setters Liaison was accepted in March 2006 by the participating NASS as reflecting the aims of the liaison activities.

Currently, the participating NASS are from: Australia, Austria, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Japan, Mexico, New Zealand, South Africa, The Netherlands, United Kingdom and United States of America as well as the Nordic Federation.

5.3 INTERNATIONAL STANDARDS ON AUDITING (ISA)

International Standards on Auditing (ISA) refer to professional standards dealing with the responsibilities of the independent auditor while conducting the financial audit of financial info. These standards are issued by International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB). The ISAs include requirements and objectives along with application and other explanatory material.

The auditor is obligatory to have knowledge about the whole text of an ISA, counting its application and other explanatory material, to be aware of the objectives and to apply the requirements aptly.

The International Auditing and Assurance Standards Board (IAASB) is an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, quality control, review, other assurance, and related services, and by facilitating the convergence of international and national standards. In doing so, the IAASB enhances the quality and uniformity of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.

he IAASB is committed to the goal of developing a set of International Standards and other pronouncements which are generally accepted worldwide. IAASB members act in the common interest of the public at large and the worldwide accountancy profession. This could result in their taking a position on a matter that is not in accordance with current practice in their country or firm or not in accordance with the position taken by those who put them forward for membership of the IAASB.

5.3.1 LIST OF THE STANDARDS

The key standards issued by the ISA include:

- Respective responsibilities
- Audit planning
- Internal control
- Audit evidence
- Using work of other experts
- Audit conclusions and audit report
- Specialized areas

5.3.2 STRUCTURE OF ISAs

Every ISA is structured in individual sections as:

- Introduction: Introductory material can include the purpose, scope, and subject matter of the ISA, as well as the responsibilities of the auditor and others in context in which the ISA is established.
- Objective: Every ISA consists of as clear statement about the objective of the auditor in the audit area addressed by that ISA.
- Definitions: For higher understanding of the ISAs, pertinent terms are delineated in each ISA.
- Requirements: Every objective is shored up by clearly stated requirements. Requirements are always expressed by the phrase "the auditor shall."
- Application and other explanatory material: The application and other explanatory material explains more exactly what is meant by a requirement or is intended to cover, or includes examples of procedures that can be appropriate under certain circumstances.

5.3.3 Objectives of the ISA:

The ISA objectives are two-fold:

- Analyzing the comparability of national accounting as well as auditing standards with international standards, determine the degree with which applicable auditing and accounting standards are complied, and analyze strengths and weaknesses of the institutional framework in sustaining high-quality financial reporting.

- Assist the country in developing and implementing a country action plan for improvement of institutional capacity with a view of strengthening the corporate financial reporting system of the country.

5.3.4 Scope of ISA:

1. This International Standard on Auditing (ISA) deals with the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with ISAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the ISAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the ISAs. The independent auditor is referred to as "the auditor" hereafter.

2. ISAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. ISAs do not address the responsibilities of the auditor that may exist in legislation, regulation or otherwise in connection with, for example, the offering of securities to the public. Such responsibilities may differ from those established in the ISAs. Accordingly, while the auditor may find aspects of the ISAs helpful in such circumstances, it is the responsibility of the auditor to ensure compliance with all relevant legal, regulatory or professional obligations.

The ISAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The ISAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, the applicable financial reporting framework and, the entity's system of internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.
- The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation.
- The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the ISAs or by applicable law or regulation.

5.4 IAASB's PRONOUNCEMENTS:

5.4.1 IAASB Authoritative Pronouncements:

The IAASB's pronouncements govern audit, review, other assurance, and related services engagements that are conducted in accordance with International Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information in a particular country required to be followed in accordance with that country's national standards. In the event that local laws or regulations differ from, or conflict with, the IAASB's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the IAASB's Standards. A professional accountant should not represent compliance with the IAASB's Standards unless the professional accountant has complied fully with all standards relevant to the engagement.

The authoritative pronouncements of the IAASB are the International Standards, which are issued following the IAASB's stated due process.

The Authority Attaching to International Standards Issued by the International Auditing and Assurance Standards Board:

1. International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.
2. International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.
3. International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements other than audits or reviews of historical financial information.
4. International Standards on Related Services (ISRSs) are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the IAASB.
5. ISAs, ISREs, ISAEs, and ISRSs are collectively referred to as the IAASB's Engagement Standards.
6. International Standards on Quality Control (ISQCs) are to be applied for all services falling under the IAASB's Engagement Standards.

Authoritative international standards on auditing:

1. ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of ISAs is set out in ISA 200.
2. International Standards on Quality Control : ISQCs are written to apply to firms in respect of all their services falling under the IAASB's Engagement Standards. The authority of ISQCs is set out in the introduction to the ISQCs.
3. Other International Standards: Some International Standards identified in paragraphs 6–8 contain: objectives, requirements, application and other explanatory material, introductory material and definitions. These terms are to be interpreted in a directly analogous way to how they are explained in the context of ISA and financial statement audits in ISA 200.
4. Professional Judgment: The nature of the International Standards requires the professional accountant to exercise professional judgment in applying them.
5. Applicability of the International Standards: The scope, effective date and any specific limitation of the applicability of a specific International Standard is made clear in the Standard. Unless otherwise stated in the International Standard, the professional accountant is permitted to apply an International Standard before the effective date specified therein.
6. International Standards are relevant to engagements in the public sector. When appropriate, additional considerations specific to public sector entities are included:

(a) Within the body of an International Standard in the case of ISAs and ISQCs; or
(b) In a Public Sector Perspective (PSP) appearing at the end of other International Standards.

5.4.2. IAASB Non-Authoritative Pronouncements

Non-authoritative material includes Practice Notes issued by the IAASB and staff publications. Non-authoritative material is not part of the IAASB's International Standards.

1. International Auditing Practice Notes

International Auditing Practice Notes (IAPNs) do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISA relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

Depending on the nature of the topic(s) covered, an IAPN may assist the auditor in:

- Obtaining an understanding of the circumstances of the entity, and in making judgments about the identification and assessment of risks of material misstatement;
- Making judgments about how to respond to assessed risks, including judgments about procedures that may be appropriate in the circumstances; or
- Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.

Practice Notes Relating to Other International Standards

The IAASB may also issue International Review Engagement Practice Notes (IREPNs), International Assurance Engagement Practice Notes (IAEPNs), and International Related Services Practice Notes (IRSPNs) to serve the same purpose for ISREs, ISAEs, and ISRSs respectively.

2. Staff Publications

Staff publications are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of IAASB pronouncements.

3. Language

The sole official text of an IAASB International Standard, Practice Note, exposure draft or other publication is that published by the IAASB in the English language.

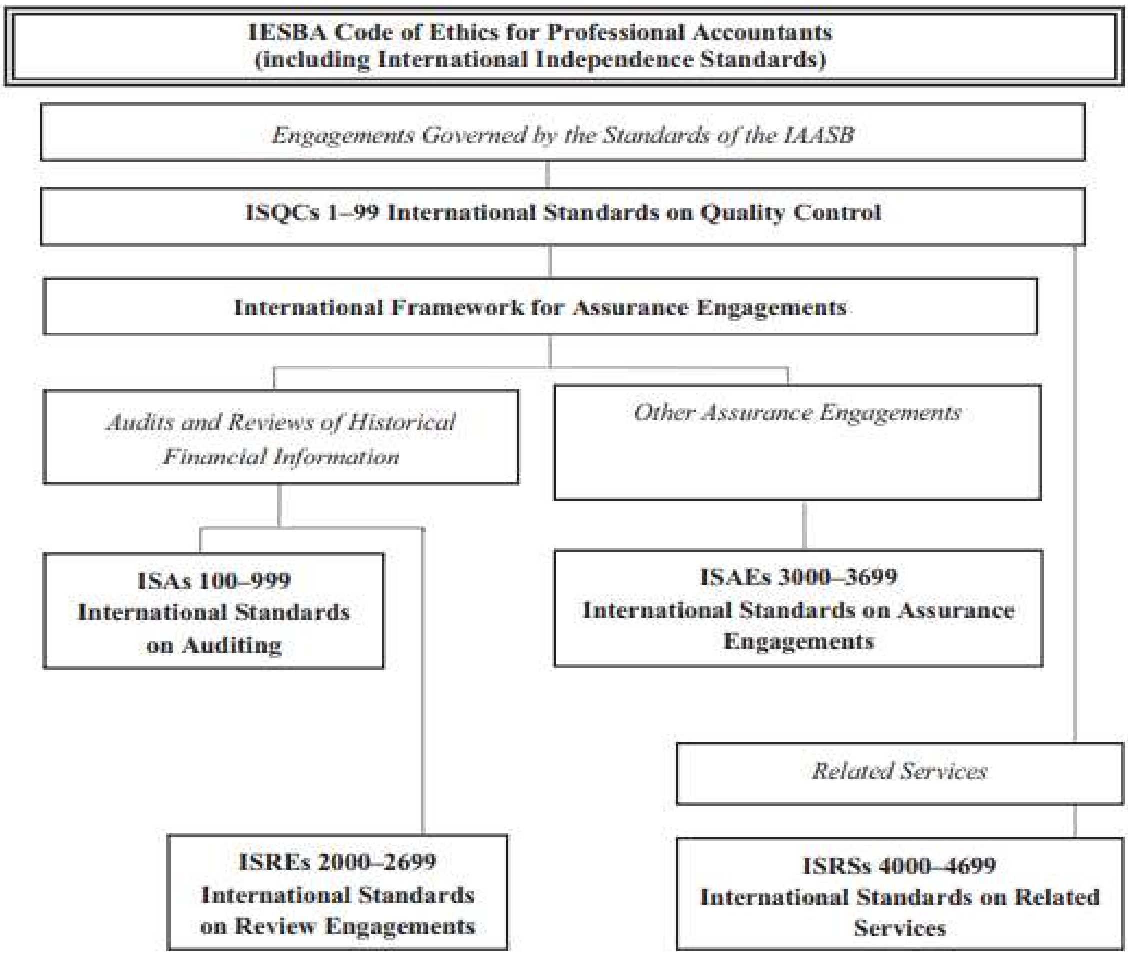
5.5 LIST OF INTERNATIONAL AUDITING AND ASSURANCE STANDARDS:

- International Standard on Quality Control (ISQC), Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements
- ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
- ISA 210, Agreeing the Terms of Audit Engagements

- ISA 220, Quality Control for an Audit of Financial Statements
- ISA 230, Audit Documentation
- ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
- ISA 250, Consideration of Laws and Regulations in an Audit of Financial Statements
- ISA 260, Communication with Those Charged with Governance
- ISA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
- ISA 300, Planning an Audit of Financial Statements
- ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- ISA 320, Materiality in Planning and Performing an Audit
- ISA 330, The Auditor's Responses to Assessed Risks
- ISA 402, Audit Considerations Relating to an Entity Using a Service Organization
- ISA 450, Evaluation of Misstatements Identified during the Audit
- ISA 500, Audit Evidence
- ISA 501, Audit Evidence-Specific Considerations for Selected Items
- ISA 505, External Confirmations
- ISA 510, Initial Audit Engagements-Opening Balances
- ISA 520, Analytical Procedures
- ISA 530, Audit Sampling
- ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
- ISA 550, Related Parties
- ISA 560, Subsequent Events
- ISA 570, Going Concern
- ISA 580, Written Representations
- ISA 600, Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)
- ISA 610, Using the Work of Internal Auditors
- ISA 620, Using the Work of an Auditor's Expert
- ISA 700, Forming an Opinion and Reporting on Financial Statements
- ISA 705, Modifications to the Opinion in the Independent Auditor's Report
- ISA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
- ISA 710, Comparative Information-Corresponding Figures and Comparative Financial Statements
- ISA 720, The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
- ISA 800, Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
- ISA 805, Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
- ISA 810, Engagements to Report on Summary Financial Statements
- IAPN 1000, special considerations in auditing Financial instruments- International Auditing Practice Notes

- ISREs 2000–2699 International Standards on Review Engagements 2400 (Revised), Engagements to Review Historical Financial Statements
- ISREs 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity
- ISAEs 3000–3399 Applicable to All Assurance Engagements
- ISAEs 3000 (Revised), Assurance Engagements Other than Audits or Reviews of Historical Financial Information
- ISAEs 3400–3699 Subject Specific Standards
- ISAEs 3400 The Examination of Prospective Financial Information (Previously ISA 810)
- ISAEs 3402 Assurance Reports on Controls at a Service Organization
- ISAEs 3410 Assurance Engagements on Greenhouse Gas Statements
- ISAEs 3420 Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus
- ISRSs 4000–4699 International Standards on Related Services
- ISRSs 4400 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information (Previously ISA 920)
- ISRSs 4410 (Revised), Compilation Engagements
- ISRSs 4400 (Revised), Agreed-upon Procedures Engagements

STRUCTURE OF PRONOUNCEMENTS ISSUED BY THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD



5.6 THE INTERNATIONAL FEDERATION OF ACCOUNTANTS (IFAC) ROLE:

The International Federation of Accountants (IFAC) serves the public interest by contributing to the development of strong and sustainable IFAC is currently comprised of more than 175 members and associates in more than 130 countries and jurisdictions, representing almost 3 million accountants in public practice, education, government service, industry, and commerce. As part of its public interest mandate, IFAC contributes to the development, adoption, and implementation of high-quality international auditing and assurance standards, primarily through its support of the IAASB. IFAC provides human resources, facilities management, communications support, and funding to this independent standard-setting board, and facilitates the nominations and selection process for board members. The IAASB sets its own agendas and approves its publications in accordance with its due process and without IFAC's involvement. IFAC has no ability to influence the agendas or publications. IFAC publishes the handbooks, standards, and other publications and owns the copyrights.

The IAASB's independence is safeguarded in a number of ways:

- formal, independent public interest oversight for standard setting by the Public Interest Oversight Board (see www.ipiob.org for more information), which includes a rigorous due process involving public consultation;
- a public call for nominations, and formal, independent oversight of the nominations/selection process by the Public Interest Oversight Board;
- full transparency, both in terms of due process for standard setting, as well as public access to agenda materials, meetings, and a published basis for conclusions with each final standard;
- the involvement of a Consultative Advisory Group and observers in the standard-setting process; and
- the requirement that IAASB members, as well as nominating/employing organizations, commit to the board's independence, integrity, and public interest mission.

5.8 QUESTIONS

Short Answer Questions:

1. Write short notes on ISA.
2. Write about IAASB.
3. Write the objectives of the auditor
4. Write about the international independent standard-setting boards

Essay Questions:

1. Explain about IFAC.
2. Explain about IAASB.
3. List out the International Auditing and Assurance Standards.

5.9 REFERENCES

1. https://www.iaasb.org/about-iaasb
2. Handbook of International Quality Control, Auditing, Review, Other Assurance, And Related Services Pronouncements, December02nd, 2021 Edition Volume I, https://www.ifac.org/system/files/publications/files/IAASB-2021-Handbook-Volume-1.pdfInternational Standard-Setting Boards https://www.international-standards.org/

- **Dr.N.Srihari**

LESSON - 6

AUDIT PROGRAMME

6.0. Object : After going through this lesson the student can know the procedure and planning of Audit. He can also know the procedure of a New Audit.

Structure :

6.1. Introduction :

After having decided as to whether continuous audit or final audit is to be undertaken the auditor should prepare himself for the work. How to proceed with the work will depend upon the circumstances of each particular case. The method of work varies with the training, experiences and knowledge of the auditor.

6.2. Procedure:

As we have already seen that the procedure of audit work will vary from case to case. Some general points are given below.

1. Distinctive ticks of different colours for say additions, postings, ledger balances, carry forwards etc. should be adopted.
2. The significance of these ticks should not be made known to the clerks of the client.
3. The same kind of tick should not be used for the same kind of transactions or for all the visits.
4. As far as possible the work of checking of one book should be completed at one sitting, otherwise some fraudulent alterations may be made by the clerks after the audit clerk has left the office for the day.
5. In every visit the audit clerk should see that there has been no alteration in the work he had already checked on the previous visit. If so, he should get an explanation and check the whole of the work again.
6. If adjustment is found to be necessary that should be carried by passing a journal entry. No alteration of a figure should be allowed.
7. Special ticks should be used for figures which had already been erased.

8. The auditor should write the correct figure with his own ink just close to the erased one and should put a circle around the erased figure with a colour pencil.
9. Sometimes the clients put the total figures with pencil. In such cases the auditor should refuse to commence his work until these figures are inked.
10. The audit clerk should not balance the books. It is not his duty.
11. The audit work should only be started after the client has closed the accounts and final accounts are prepared.
12. No transaction should be passed unless he understands and believe it as true.
13. The auditor should not discuss anything in regard to the meaning of different ticks with the client's staff.

6.3 Preliminary steps:

The audit of accounts of a concern involve sound planning, conduct and judgement. An auditor has to take certain steps before commencing the audit such steps are called preliminary or general steps. They are as follows.

1. He should see that his appointment is in accordance with the provisions of the companies act. If he does not do so he will be held liable. If he has been appointed in place of an other auditor, he should enquire from the retiring auditor the reasons for changes.

V.G. Majundar Vs J.N. Saika 1954:

1. A chartered accountant was appointed by the Directors because the company had failed to appoint the auditors in its annual general meeting. The chartered accountant wrote to the previous auditor of the company about the appointment but finished the work of audit on the same date before the receipt of any reply. It was held that the auditor was guilty, but since it was found that there was misapprehension the auditor was given a warning.
2. He should obtain definite instructions from his clients about the nature and scope of his work and duties whether he has to do the accountancy work or Audit work or both.
3. He should examine the system of accounting employed by his client. If he finds any week points he must study it thoroughly and make recommendations to his client to remove these week points.
4. He should then obtain a list of all books maintained in the office together with the names of the keepers of such books and their specimen signatures, such a list should be duly signed by a responsible official of the company.
5. If internal check system is in operation, he should get a written statement to that effect and should decide whether to rely or not on it.
6. He should get a list of the officers of the company containing particulars about their duties, powers and their specimen signatures.
7. If the business is of a technical nature it would be better to visit the work and acquire technical knowledge to some extent before he actually commences the work.
8. He should ask the clients to balance the books and prepare the final accounts and the Balance

sheet, file the vouchers in the order of occurrence of the transactions, prepare the schedules of the debtors good, doubtful and bad, creditors. Important legal papers, contracts, list of securities etc. If this has not been done so far he should never begin his work until the books have been balanced.

9. He should obtain the previous years audited Balance sheet, if any and see that the accounts during the current year have been opened with those balances which appeared in the previous Balance sheet.

10. He should carefully study all the documents which have a bearing on the accounts. He should study the partnership deed in case of partnership audit. Memorandum and Articles of Association in the case of company audit and trust deed in case of a trust audit.

11. If it is the first audit of a company he must also go through the prospectus, contracts with the vendors, promoters etc.

12. He should get the report of the auditor, if any relating to the accounts of the previous year for information regarding the state of affairs of the company during that year.

13. He should draw up an audit programme.

6.4 Audit Programme:

An audit programme is an essential preliminary to an efficient audit. Hence the auditor should prepare it before the commencement of the audit work. An audit programme is a written scheme of the exact details of the work to be done by the auditor and his staff in connection with a particular audit. It contains the selected periods for tests, dates of work, names of persons performing the work and time taken.

According to Prof. Megis, an audit programme is a detailed plan of the auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements and giving the estimated time required.

Audit programme is generally prepared with the columns provided for the name of the clerk doing the work, the type of work the dates when he started and finished the work. Each audit assistant signs for the work, he has performed so that the responsibility may rest upon him for the work he has done.

A specimen of Audit programme is as follows.

SPECIMEN OF AUDIT PROGRAME

Messers ....& Co., Ltd.

YEAR MONTHS	Cash Book	Bank Balance	Cash Book	Petty Cash	-do-	Bought Ledger	Bought Ledger	Sales Book Additions and	Returns Book	Journal	Stock - Sheet	Bought Ledger Balances	Sales Ledger	Trial Balance	General Ledger	Profit & Loss	Balance Sheet	Remarks
JAN.																		
FEB																		
MARCH																		
APRIL																		
MAY																		
JUNE																		
JULY																		
AUGUST																		
SEPT.																		
OCT.																		
NOV.																		
DEC.																		

N.B. : Each audit assistant has to put in his initial in the relevant column after he has checked a particular item.

Advantages of Audit Programme:

The advantages of audit programme may be listed out as follows:

1. It ensures that all necessary work has been done and nothing has been omitted.
2. The auditor is in a position to know about the progress of the work done by his assistants.
3. A uniformity of work can be attained as the same programme will be followed at subsequent audits.
4. Work of the audit can be divided amongst the different juniors who will be responsible for their work. In case a clerk goes on leave, his work can be resumed by another clerk who is in a position to know what work has already been done.
5. It simplifies the allocation of work to various grades of audit clerks.
6. In case of a charge of negligence against the auditor for not having done some work, the auditor can defend himself that the work had been done by him or his assistant who had duly signed the audit programme.
7. It is a kind of guidance to the audit clerk for the work he has to perform. Thus it is a kind of assurance to the auditor that the junior will not overlook essential points while checking the accounts.
8. In case of any fraud or error has remained undetected, the responsibility for negligence can be fixed on the clerk who had performed that work as his initials are put on the audit programme.
9. It facilitates the final review before the report is signed.
10. For a new clerk the audit programme is a guide to his duty.
11. It is a useful basis for planning the programme for the subsequent year.

Disadvantages of Audit programme:

There are however, certain disadvantages of such an Audit programme which may be listed as follows:

1. The audit may become too mechanical in its nature. Audit programme discourages initiative and interests of the assistants.
2. The audit programme even if it is well chalked out may not cover every thing that might come up during the course of audit.
3. New matters of importance arising between one period and an other may be overlooked, if the programme is not kept up to date.
4. Work may be hurried in order to complete a required schedule.

These disadvantages are not quite serious. They can be easily overcome by following certain precautions are as follows:

The auditor should consult the juniors while chalking out a programme. Their suggestions should be appreciated. So that they may not lose initiative. They should be encouraged to make surprise checks outside the audit programme and to recommend additions and improvements in the scheme. As far as possible the audit programme should be made up-to-date on the basis of experience gained and change taking place. In other words great care must be taken to ensure that the programme does not become obsolete. Efforts should thus be made to remove the disadvantages rather than avoiding chalking out the programme itself.

6.5 Audit Note Book:

An audit note book is a book which is maintained by the audit clerk. During the course of audit, the clerk comes across several difficulties or new points which he has to discuss with his senior or the auditor. He notes down these in a book which is called audit note book or Audit memoranda. Every auditor maintains an audit note book for the purpose of making notes of all important matters affecting the audit. The audit note book is of great use to the auditor. It helps the auditor to a great extent in future; specially in subsequent audits of the same concern. If the auditor is charged with negligence in his work, he may produce audit note book as evidence and show the exact work done by him and defend himself from being put in a difficult situation. Thus the audit note book is a documentary evidence in favour of the auditor.

The audit note book should be maintained clearly, completely and systematically. It should not contain the notes of unimportant matters.

The Audit Note Book should be in two parts.

1. for keeping a record of general information as regards the audit as a whole and
2. for recording special points which the audit staff may have come across during the course of audit of the accounts of different years.

An audit note book should contain the following information:

General information:

1. The nature of the business carried on and the important documents relating to the constitution of the business i.e.; Memorandum of Association, Articles of Association and partnership Deed etc.
2. A list of books of accounts in use.
3. Names of principal officers, their duties and responsibilities.
4. Particulars of the accounting and the financial system followed and the internal check in operation in the business.
5. Details regarding accounting and financial policies followed in the business.

Special matters to be recorded in the Audit Note Book:

1. Routine queries not cleared, i.e.; missing receipts and vouchers, etc.
2. The mistakes and errors discovered.
3. The points arising during the course of the audit, to which the attention of the auditor must be draw, i.e.; failure of the company to comply with the provisions of the companies Act or of the Memorandum of Association.

4. Extracts from minutes and contracts etc;
5. The points to be incorporated in the audit report.
6. The points which need further explanation and clarification e.g; a change in the basis of valuation of finished stock or in the computation of depreciation etc;
7. Dates of commencement and completion of the audit.
8. Important matters for future reference.
9. Special points requiring consideration at the time of final accounts.

Audit Note Book should be preserved by the auditor in order to avoid any type of liability which may arise in future. It is also a good reference book for future audit.

6.6. Working papers:

Working papers are those papers which contain essential facts about accounts so that the auditor may not have again to go over the accounts of his client in case he wants to refer to them later on during the course of his audit.

Objects or Aim of working papers:

The objects or Aims of working papers are as follows:

1. In order to support the auditors report these papers show the details of the work performed by the audit clerks.
2. An auditor can form an opinion about the efficiency of the audit clerk, as the working papers remain with the auditor.
3. They are permanent records and therefore in case of any suit against him for negligence, he can defend himself on the basis of these working papers.
4. The preparation of the working papers is a means to give training to the audit clerks as to how to summarise the work done by them.
5. The working papers enable the auditor to point out to the client the weaknesses of the internal control system in operation.
6. The working papers help the auditor to plan for the succeeding year.
7. It will enable the auditor to prepare the report without much waste of time.
8. He can know that his assistants had followed his instruction.

Working papers should be carefully prepared as they are the basis of conclusions and summarisations shown by the auditor in his report. They should be clear, complete and contain all essential information in regard to accounts and audit so that they may be of maximum utility. They should be properly organised and arranged so that one may not find difficulty in pin-pointing a particular matter.

8.A Essentials of good working papers:

1. The working papers should contain all the essential information so that they may be of maximum utility.

2. The working paper should be so arranged that one may not find any difficulty in locating a particular matter. If they are not properly arranged it will result in loss of time in finding a particular fact while preparing the report.
3. The facts in the working papers should be set out clearly.
4. The facts stated should be readily available to the reader later on.
5. Paper used for working papers should be of good quality so that by frequent handling it may not be damaged.
6. Paper used should be of convenient and uniform size.
7. Sufficient space should be left after each note so that any decision taken by the auditor may be taken down in that space.
8. Papers should be arranged in a logical order.

Preservation and filing of working papers:

It is necessary that the working papers should be preserved as they are important and valuable documents for the clients as well as for the auditor. It is therefore suggested that they should be filed systematically. For convenience, the working papers may be sub-divided between current and permanent files.

The current files should normally include the following documents

a) A copy of the accounts under review.
b) The audit programme and audit tests performed.
c) Minutes book of the directors and share-holders meetings or the board of trustees or partners.
d) Queries raised during the audit and the official comments.
e) Letters from clients and other sources confirming account, certificate for valuation of stock and provision for bad debts, etc.
f) A list of missing vouchers.
g) Bank and branch reconciliation statements.
h) Computation of tax, bonus and gratuity etc.

The permanent file should normally include following documents.

a) A copy of the memorandum of association and articles of association, partnership deed and trust deed etc.
b) A copy of the relevant statutory regulation.
c) A brief note on the nature of the business.
d) A copy of the letter containing client's instructions as to the work to be performed.
e) A list of important books maintained by the client.

f) A list of officials with the nature of work performed by them and a copy of the organizational chart.

g) A short description of the system of internal control and internal audit in operation.

h) Statements setting out the basis of stock valuation and computation of depreciation etc.

6.7. Summary :

The procedure of audit work will vary from case to case. The audit of accounts of a concern involve sound planning conduct and judgement The steps which the auditor take before commencing the audit are called preliminary or general steps. The auditor should chalk out a programme before commencement of the audit work. It is a written scheme of the exact details of the work to be done by the auditor and his staff in connection with a particular audit.

During the course of audit, each audit clerk maintain a book to note points which he has to discuss with his senior or the auditor. This book is known as Audit note book.

The auditor, while auditing the accounts prepare certain papers which contain essential facts about accounts which will help to prepare his report without much difficulty. These papers also will be filed for future use.

6.8. Self Assessment questions:

1. What is an audit programme? and what are its objects ?
2. What steps an auditor should take before commencing a new audit ?
3. What is an "Audit note book" ?
4. Describe an Audit note book. What are its contents and its value to an auditor ?

6.9. Recommended books

Principles of Auditing	**:**	**R.G. Saxene**
Principles & Practices of Auditing	**:**	**B.N. Tandon**
Principles & Practices of Auditing	**:**	**Jegadish Prakash**
Contemporary Auditing	**:**	**Kamal Gupta**

Dr. Ch. Suravinda

LESSON - 7

INTERNAL CHECK

4.0. Object : After going through this lesson the student can know what is internal check ? What are its advantages ? How can the work of internal check is drafted in case of cash receipts and payments, purchases, sales, wages etc.

Structure :

7.1. Introduction :

Internal check is a method of organising the accounts system of a business concern or a factory where the duties of different clerks are arranged in such a way that the work of one person is automatically checked by another and thus the possibility of fraud or error is minimised unless there is a collusion between the clerks; e.g; the receipt of cash is entered by the cashier on the debit side of the cash book, this entry is carried to the ledger by another clerk, the statement of account relating to this transaction is sent to the customer by a third clerk and so on. It is a kind of division of labour. This minimises the possibilities of frauds and errors unless all the three join hands in defrauding their employer. The secret among three will be a secret for all is true in this case.

7.2. Definition :

F.R.M. De Paula defines it as "Internal check means practically a continuous internal audit carried on by the staff itself, by means of which the work of each individual is independently, checked by other members of the staff".

L.R. Dicksee, defines internal check as "Such is arrangement of book-keeping routine that errors and frauds are likely to be prevented or discovered by the very operation of the book - keeping itself."

American Institute of Accountants, 1949, defined internal check as "Internal check- system under which the accounting methods and details of an establishment are so laid out that the accounts and procedures are not under the absolute and independent control of any one person that on the contrary, the work of one employee is complementary to that of an another and that a continuous audit of the business is made by employees".

Thus the system is based on the principle of division of labour that is the work in the organisation, is arranged in such a way that the work performed by one individual is checked by another automatically.

7.3. Objects of Internal Check :

The internal check system is organised to achieve the following objects:

1) To prevent the commission of any error or fraud by a clerk.
2) To prevent the misappropriation of cash or goods by any clerk by keeping a check on the receipts and payments of cash and receipts and delivery of the goods.
3) To throw responsibility on a particular clerk when the fraud or mistake is detected.
4) To detect a fraud or an error quickly and easily.
5) To have an accurate record of all business transactions.

7.4. Essentials of good Internal check System:

The following points are to be taken into consideration in framing a good system of internal check.

1) No single person should have an independent control over any important aspect of business for ex ; When goods are purchased on credit, entries are made in the purchase book by the gate-keeper he enters the name of the supplier, the quantity of goods and the date on which they are received; another entry is by the keeper of the purchase book, in the purchases book. Thus, the same staff by different clerks and the possible of fraud or mistake is reduced to a transaction is entered.
2) The duties of the members of the great extent be changed from time to time without prior notice.
3) Every member of the staff should be instructed to go on leave at least once. This will help in detecting the conceal frauds.
4) Persons having physical custody of assets must not be permitted to have access to book of accounts.

5) To prevent misappropriaton of cash, mechanical devices should be employed.

6) Procedures should be laid down for the verification and testing of different sections of accounting records periodically, to ensure their accuracy.

7) The financial and administrative powers should be assigned to different officers.

8) For stock taking at the close of the year, the trading activities should be suspended for some time. The task of pricing and evaluation of stock should be done by the staff other than that of stock section.

9) No member of the staff should be allowed to take away goods without prior permission of some responsible official.

10) There should be efficient accounting control in respect of each important class of assets.

11) Ledger keepers should not be allowed to have a direct access to either the debtlors or creditors of the business.

12) A detailed record should be maintained for all goods received and sent out of the business premises.

7.5. Auditor's duty in regard to Internal check system :

To what extend should an auditor depend upon the internal check system will depend upon the magnitude of the business whose accounts he is auditing.

In the case of a concern where there is no internal check system and the clerk has full control over all the books of accounts. It would be better if the auditor should check all the transactions from the beginning to the end irrespective of the fact whether the concern is small or big.

In the case of concern where there is a good internal check system, the auditor, may rely upon it to a great extent. But he must not be negligent. He should apply a few test checks. The existence of a good internal check system reduces to a great extent the work of the auditor but does not reduce his liability. To what extent should an auditor depend upon the internal check system will depend upon the circumstances of each particular case and the efficiency of his audit will depend upon his tact, skill, experience and judgement.

7.5. Internal control :

Control is a wider term and will include all types of management controls. It is a means of assisting modern business management in discharging its function. The term internal control has been defined as "the whole system of controls, financial or otherwise established by the management in order to carry on the business of the company in an orderly manner safe guard its assets and secure as far as possible the accuracy and reliability of its record." According to this definition, internal control means a/. accounting control b/. operation controls i.e.; quality control, budgetary control, internal checks and internal audit etc.

a) Accounting controls :

Comprise primarily "the plan of organisation and the procedures and records that are concerned with and directly related to the safeguarding of assets and reliability of financial records." Accounting and financial control include budgetery control, standard costing, self balancing ledgers and internal auditing etc. such controls ensure accuracy and reliability of financial records

b) Administrative controls :

Comprise the plans of organisation that are concerned mainly with operational efficiency. They may include controls, such as time and motion studies , quality control through inspection, performance reports and statistical analysis.

7.7. Internal control and the Auditor :

From the definition given above, that it is the responsibility of the management to instal internal control in order to carry on business of the company in an orderly manner. The institute of Chartered Accountants of India also stated the duty of safeguarding the assets of a company is primarily that of the management and the auditor is entitled to rely upon the safeguards and internal controls instituted by the management. Therefore an auditor is mainly concerned with the evaluation of the internal control system in force so that he may be able to know.. Certain things which may be listed out as follows.

1) whether mistakes, errors and frauds are likely to be located in the ordinary course of operation of the business;

2) whether an efficient internal auditing department exists or not;

3) how far the management is discharging its function in regarding to correct recording of the transactions;

4) how extensive examination he should carry out in the different areas of accounting;

5) how far administrative control has a bearing on his work;

6) What should be the appropriate audit programme in existing circumstances;

7) to what extent he can depend on the records and reports of the management.

If the auditor does not acquaint himself fully with the internal control system and its actual operations he cannot formulate a satisfactory audit programme.

7.8. Internal Audit :

Internal Audit is the review of operations and records under taken within a business by specially assigned staff. The term internal audit has been defined as "the independent appraisal of activity within and organisation for the review of accounting, financial and other business practices as a protective and constructive arm of management". From this definition it is clear that internal audit not only includes the verification of accounting matters but also financial and other matters.

The work of the internal auditor is more or less the same as that of an external auditor. Being the employee of the organisation he has to see that there is no waste and inefficiency in the organisaiton. He has to find out weakness of the internal control and internal check systems followed in the organisation and suggest necessary improvement. Internal auditor assist management in achieving the most efficient administration of the organisation.

Differences between internal Auditor and Independent Auditor.

Internal Auditor	Independent Auditor
1) He is an employee of the concern. His duties, rights and responsibilities regarding audit work are determined by the management.	1) He is appointed under statute and his scope of work and liability etc are laid down by the statute.
2) Internal auditor is appointed by the management.	2) He is appointed by the shareholders or by the Government.
3) It is optional to appoint an internal auditor.	3) It is compulsory.
4) He need not be a qualified auditor.	4) He must satisfy the qualifications mentioned in companies Act.
5) He presents accounting information to the management continuously to take policy decisions.	5) He ensure the shareholders that the financial statements show a true and fair view of the financial position of the company.
6) He has to submit his report to the management.	6) He submits his report to the shareholders through the management.
7) His work is continuous in nature.	7) His work is periodical in nature.

7.9. Internal check as regards cash receipts

There are lot of chances of misappropriation of cash if there is no well organised system of Internal check. He should enquire as to the duties of the cashier and whether he has access to the ledger and other books of original entry. If it is so, there are chances of fraud and therefore he should be vigilant. The following steps of internal check as regards receipts is suggested.

1) When cash is received, it should be acknowledged by means of a printed receipt which should have a counterfoil or by a carbon copy. Cashier should not sign receipts and counter foils. The receipts should be consecutively numbered. The unused receipt book should be kept under lock and key. Spoiled receipts should be cancelled and must not be detached from the counterfoils. No blank counterfoils should be accepted.
2) As soon as cash is received it should be entered in a rough cash book or diary
3) Remittances should be opened by the cashier in the presence of a responsible officer who should not be connected with the cashier's office. All cheques received should be crossed.
4) All the receipts of the day should be deposited in the bank at the end of the day or the next morning.
5) Bank recociliaton statement should be prepared frequently by the cashier and also by some one else.

6) The cashier should not have any control over the ledgers.

7) Petty cash should be organised under the imprest system.

8) Before a cheque is issued it should be presented along with the account of the payee, to a responsible officer who should not have any access to accounting records or securities for his signature. Unused cheque book should be kept under lock and key by a responsible official.

9) Castings of the cash book should be independently checked.

10) Internal control over the preparation of wage sheets to prevent fraud and manipulation should be exercised.

11) All payments as far as possible except for petty cash, should be made by cheques.

12) If travellers are permitted to collect money on behalf of the company, the issue of receipts by them and deposits of such money into the bank should be carefully controlled. As far as possible the system of collection by the travellers should be discouraged. The travellers should be given receipt books having three copies -one to be given to the customer, another to be sent to the head office and the third to be retained by them.

13) Cashier should not sanction the payments of special nature. Directors should do so.

7.10. Internal check as regards cash payments :

1) All payments should be through crossed cheques.

2) Petty cash payments should be handled by the petty cashier. This books should be maintained under imprest system.

3) For all payments made vouchers should be checked with relevant vouchers.

4) All cheques and bills should be thoroughly checked and signed by the proper authority.

5) Confirmation of accounts with the creditors should be made to maintain up-to-date records.

6) All vouchers should be serially filed.

7) Bank reconciliation statement should be prepared frequently.

7.11. Internal check as regards sales :

In big business concerns a separate department to deal with sales is kept. This is under the supervision of a responsible official known as sales manager. Following procedures should be adopted to control sales :

1) Whenever an order is received, it should be recorded in the order received book, giving details regarding the date on which the order was received, the name of the customer, the particulars about the goods, date of delivery mode of transport etc.,

2) The copy of the order is sent to the Despatch Department.

3) When the Despatch Department has packed the goods, another clerk should compare the goods so despatched with the order to see that the whole of the order is complied with or

another list is prepared showing the goods in the package which list is sent to the counting house.

4) A responsible official will now mark the rate at which the goods are to be charged.

5) A clerk will make the calculations.

6) The outward invoice is then prepared in duplicate.

7) One copy of the invoice will be sent to the invoice clerk who enters, it in the sales book and later on this is sent to the customer, another copy will be sent to the gate-keeper who will record in the goods outward book the third copy is filed for further reference.

8) If orders are received through the travellers, they should be given order books with tripicate copies - one copy to be handed over to the customer, the second to be sent to the Head office and the third one is to be retained by the traveller for his record.

The Duties of Auditor in connection with credit sales :

1) He should see that whether the internal check system in operation is efficient or not. If it is not so, he should disown his responsibility. If it is efficient, he should apply a few test checks.

2) He should compare the data of invoices with the data in sales book.

3) He should see that the sale of an asset is not treated as ordinary sale.

4) With the permission of the client, the auditor should send statements of Accounts to the customers to confirm the accuracy of the balance.

5) He should check the sales book for the last days or weeks of the financial period and the returns. Inward book for a few days or weeks after the close of the period in order to see whether fictitious sales or returns has been recorded to inflate profits.

6) He should check the casts of the sales Book.

7) The cancelled invoices, if any, should be checked with the duplicate copy of the invoice.

8) Sales tax, insurance charges etc., which are recoverable from the customers should be debited to the customer's account.

9) Sales to allied or sister concerns should be carefully examined as they may be fictious.

10) If there is a significant difference of trade discount allowed to two different purchasers, he should inquire into the reasons of such a distinction.

Sales Returns :

When the goods are returned from customers, defective or an account of any other reason, they should be entered by the gate keeper in the register known as gate-keeper's Returns Inward Book and the Stock Register. The goods returned should also be recorded in the sales returns book and a credit note should be prepared to be sent to the customers. Such a credit note should be signed by a responsible official. There are lot of chances of fraud in connection with the sales returns e.g: The goods might not have been returned but a credit note has been sent to the customer. The auditor should, therefore, pay particular attention to such transactions.

Sometimes the customers attempt to return the goods if there is a fall in the prices after the purchase has been made. The auditor should pay attention to such a return of goods. Return from allied or sister concerns should be carefully examined to see their genuineness. The auditor should vouch these transactions with the gate - keeper's Returns Inward Book and with the carbon copies of the credit notes sent to customer or, the debit note received from the customers. He should see that returns just before the date of balancing the books are recorded both in the stock as well as in the Sales Returns Book. If they are taken into stock, but are not entered in the Sales Returns Book, result in hike in profits

Goods sold on sale-or return system :

Sometimes goods are sold to customers on approval i.e., the goods are delivered to customer on condiiton that if he does not approve of the goods, he can return them within a particular period. Until the customer approves the goods they cannot be treated as sales. The auditor should, see that until the approval, such goods must be shown as goods with customers and deducted from sales of the current period and from the list of the debtors.

Goods sent on consignment :

When the goods are sent out to agents to be sold at the owner's risk, a separate book called 'cosignment outward journal; should be maintained if the number of such transactions is large. This book should be vouched with the copies of the proforma invoice, account sales and contracts with consignees. The unsold goods with consignees should not be treated as sales but should be shown in the balance sheet as 'goods on consignment'.

7.12. Internal check as regards Purchases :

A big business concern should have a separate purchase department in order to have proper and effective control over purchases.

The department requiring supplies or assets, must send requistion to the purchase department. These requistion must be prepared in duplicate. The details about the quantity, quality and the time by which the goods must be supplied should be clearly stated in the requistion slip.

The purchase department after searching the best vendor or supplier will prepare four copies of the purchase orders. One copy will be sent to the vendor, second to the stores and third will be forwarded to the accounting department. The purchase order should be carefully written and must be approved and authorised by the head of the purchase department or officer authorised to do this work.

In receipt of goods, the purchase department should properly inspect them and must compare with the purchase order. Goods received should also be entered in the goods Inwards Books. The purchase department then send the goods to the stores and will also inform the concerned department about the receipt of the goods.

After a thorough check these invoices should be sent to the accounting department for payment. The accounting department should compare the invoice with the purchase order and the inspection report of the purchase department and should also verify the calculations. If found correct a record must be made in the purchases book. Payment of the verified invoices should be authorised by a senior officer. If some portion of the goods are returned to the supplier, proper entry must be made in the Purchases Return Book. A credit note to that effect must be obtained from the supplier and the accounts section must be informed accordingly.

7.13. Internal check as regards wages :

There are many chances of misappropriation of cash under this head. The chances of fraud or errors are there by inclusion of fictitious names of dummy or ghost workers in the wages book ? Over-stating of rates of wages, over-stating of hours of work or days of work put in by the workers etc. All these may mean withdrawal of more money than is actually needed for payment to the workers.

The following internal check for the payment of wages is however, suggested to avoid fraud.

Workers are paid their wages normally on the basis of the time spent by them. Therefore the time spent by each worker should be correctly recorded in the time record books. Each worker is provided with a time card. He should punch his card at the time of arrival and departure from the place of his work.

The purchasing of card must be supervised by the time keeper. In addition to strengthen the internal check system, the foreman of each department should be asked to keep the records of the time of his employees. At the end of the day the time-keeper and foreman should separately prepare the time records and the name of absentees.

If the workers are paid on the basis of piece - wages system, the proper books for recording the actual work done by workers should be maintained. A job card should be given to each such worker. The actual work done by a worker should be recorded on this card which should be counter signed by the foreman of the department as well as by the store helper to whom the goods produced are to be delivered. The quality of the work and job card should be finally checked by the piece-work-reviewer.

Sometimes workers are allowed to work overtime. In such cases overtime slips must be issued to such workers by the properly authorised official. No worker should be allowed to work overtime unless he is authorised to do so by the authorised officials of the organisation.

The preparation of wages sheets should be done by a separate department. This work should be done at least by four clerks, so that irregularities may be minimised. For time workers and piece workers separate wage sheets must be used. All the clerks who delt with wage sheets should initial the wage sheets before they are signed by the works manager.

The payment of wages must be made by a person who is in no way concerned with the preparation of wage sheets. The cashier should with draw the net amount as shown by the wage sheets. Wages should be paid to the workers personally. The foreman of each department should be present at the time of payment to identify the workers of his section. If possible the signatures of the workers must be obtained when they receive the amount of wages, cashier foreman or works manager should attest these statements. Wages may be handed over to the fellow worker only if he is authorised in writing by the absentee worker. A list of unpaid workers should be prepared by the cashier and the foreman of the department. If casual workers are also employed in the organisation, a list of such workers must be prepared by the foreman of each department. A surprise visit of a senior official while the wages are disbursed will be an effective measure of control.

7.14. Internal check as regards stores :

To preserve finished goods and raw materials a store is essential. To prevent pilferage and misuse proper control of stores is necessary. The following points may be of great help for effective control of stores.

1) Store should be located at a convenient place.
2) Goods received in the store must be entered into goods received sheets. These sheets should be prepared in triplicate - one for the purchase section, second for accounts section and the third copy to be retained in the store.
3) Goods received should be stored at their allotted racks.
4) The system of bin cards should be used to show the receipts, issues and balances of stores.
5) Stock - taking should be carried out at regular intervals.
6) Storekeeper should issue the goods only against proper, approved and authorised requisition.
7) A gate pass should be given to authorised persons who will take out the goods from the store.
8) When materials are returned from the job or by some department a "Material Returned Note" should be prepared.

7.15. Test check :

In those business houses where a satisfactory and effective system of internal check is in operation, it is not necessary for the auditor to do detailed checking. The usual practice is that a certain number of entries of each class is selected and checked and if they are found correct, the remaining entries are also taken to be correct. This is known as "Test checking". The selection of items and the extent of test checking would mainly depend upon the auditor's judgement and assessment of a particular situation.

Test checking can be of immense help to the auditor as it will reduce his work and he can devote his time to the more important sections of the work. But it should be kept in mind that test checking does not relieve an auditor from his liability if in future mistakes are detected. In applying test checks in auditing the following precautions must be taken.

1) Entries selected for test checking should be representative.
2) Selection of items to be checked should be at random.
3) A number of entries for the first and the last month of the period covered by the accounts should be checked.
4) Cash book should be thoroughly checked. Test check should not be applied to cash book.
5) Periods and entries selected for test check should be different at each audit.
6) The auditor should always change the methods of test checking.

7) The method of test checking should be kept secret from client's staff.

Advantages of test checking :

1) The volume of work is reduced. It saves time.

2) There is a moral check on the clients staff as they do not know the period or portion of work which will be taken up for test checking.

Limitations :

There are few limitations of test checking. Since test checking is based on the selection of the representative items, it is always possible that some of the errors or frauds remain undetected. Secondly the client's staff may become careless because they know that their work will not be checked in detail by the auditor.

7.16. Summary :

Internal check is a kind of division of labour. This minimises the possibilities of frauds and errors. It throw responsibility on a particular clerk when the fraud or mistake is detected. Internal control involves all types of management controls. Internal audit is carried by the staff to review the operations and records undertaken within the business. The system of internal check adopted to each type of transaction is different from other. To avoid a detailed checking of each and every transactions, the method of test checking may be adopted by the auditor if there is an efficient system of internal check in the concern.

7.17. Self Assessment questions :

1) What is meant by the term internal check ?

2) What are the objects of internal check ?

3) Prescribe the system of internal check for sales, purchases, wages.

4) Distinguish between internal check, Internal control and internal audit.

5) What should be a good system of internal check as regards cash receipts and payments.

6) What is test check ?

7.18. Recommended Books

Principles of Auditing	:	**R.G. Saxene**
Principles & Practices of Auditing	:	**B.N. Tandon**
Principles & Practices of Auditing	:	**Jegadish Prakash**
Contemporary Auditing	:	**Kamal Gupta**

- Dr. Ch. Suravinda

LESSON - 8

VOUCHING

8.0. Object : After going through this lesson the student can know what is vouching ? How the Auditor vouch the cash transactions and trade transactions.

Structure :

8.1. Introduction
8.2. Definition
8.3. Importance of vouching.
8.4. Points to be noted while vouching.
8.5. Vouching of cash transactions.
8.6. Vouching the Debit side of cash book.
8.7. Vouching the credit side of cash book
8.8. Vouching of Trading transactions
8.9. Purchases book - purchase returns book.
8.10.Sales book - Sales returns book
8.11. Summary
8.12. Model questions
8.13. Reference books.

8.1. Introduction :

Examination of the documentary evidence in order to ascertain the accuracy and authenticity of entries in the accounts books is called "Vouching". Vouching is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiation a transaction. Vouching means a careful examination of all original evidences i.e., invoices, statements, receipts, correspondence, minutes and contracts etc. With a view to ascertain the accuracy of the entries in the books of accounts and also to find out, as far as possible, that no entries have been omitted in the books of accounts.

8.2. Definition :

According to Dicksee : "Vouching consists of comparing entries in the books of accounts with documentary evidence in support thereof".

According to Joseph Lancaster : "It is often thought that vouching consists of the mere examination of the vouchers or documentary evidence with the book entries. This, however is quite wrong, vouching comprises such an examination of the ledger entries as will satisfy the auditor not only that the entry is supported by documentary evidence but it has been properly made upon the books of accounts".

From all these definitions it is clear that vouching means testing the truth of entries appearing in the primary books of accounts.

8.3. Importance of vouching :

Vouching is the essence of auditing. Success of an audit will depend upon the thoroughness with which vouching is completed. It is an important tool in the hands of an auditor and the success of an auditor in vouching depends upon his intelligence, commonsense, observation and tact with which he handles his work. An auditor should not merely check the arithmetical accuracy of the books or compare the entries with the available documentary evidence but he should go to the source of a transaction. If he simply compares the entry, say, on the credit side of a cash book with the voucher, it is possible that he might be deceived e.g; the purchase might not have been for the business or the receipt might have been for the previous year.

8.4. Voucher : Points to be noted while vouching :

A voucher is a documentary evidence in support of a transaction in the books of account. It may be a receipt, counterfoil of a receipt book, an agreement, resolution passed by the Board of Directors or shareholders, an invoice, bank paying in-slip. Bought note, sold note, correspondence, gate keeper's books, wages book, order book and so on.

While examining the vouchers, following points must be born in mind :

1) All the vouchers are consecutively numbered and filed in order of the entries in the accounts. If the client has not done so, the auditor has a right to ask him to do so. If they are not properly arranged, much valuable time will be lost in finding out a particular voucher to check it.

2) He should pay attention to the dates which must correspond with the cash book, name of the party to whom the voucher is issued the name of the party issuing the voucher and the amount etc.

3) The voucher inspected should be cancelled by a stamp. In case stamp is not available the audit clerk should affix his initials or put a tick right across the face of the voucher. Such a mark of stamp should be put in the centre of the voucher to avoid its removal by a dishonest clerk.

4) Special attention should be paid to those vouchers which are in the personal name of one of the partners, directors, or secretary etc. In such a case original invoice, goods inward book should be examined to find out whether the goods were purchased for the business or not. He should ask his client to issue instructions to the suppliers not to address the vouchers to any individual of the firm or the company.

5) He should see that every voucher is passed as order by a responsible officer.

6) He should also note whether the voucher is stamped if the amount of the voucher is above twenty rupees.

7) He should also find out the nature of payment as to whether it relates to the business.

8) He should see the nature of payment whether capital or revenue. This is important as wrong posting will effect the profit and loss account and ultimately the Balance sheet.

9) Attention should be paid to the amount both in words and figures. If they differ the, matter should be investigated.

10) Note should be made of any item which requires further elucidation or information or evidence which is available from partnership deed, contracts, Articles of Association etc.

11) If duplicate voucher for a missing one is produced it should be properly scrutinised to avoid any fraud. Reasons and explanation for their loss should be obtained from the client and if the auditor is not satisfied with the explanation, he should mention this fact in his report.

12) The audit clerk should not take the help of any members of the staff of the client.

13) Receipted invoice should not be accepted as a voucher because there is a danger of the payment being made twice. Once as a credit purchase and again as a cash transaction against the receipted invoice.

14) Sometimes business houses issue their own printed receipts which are considered as vouchers, in such a case the auditor should get more documentary evidence such as statement or invoice.

15) While examining the vouchers for insurance, rent, rates, taxes etc, the audit clerk should note the period for which the payment has been made. If the payment is made for some months in advance, proper adjustments should be made.

8.5. Vouching of cash transactions :

The auditor after satisfying himself that there is a good internal check system regarding the receipts and payments of cash, the audit clerk should now proceed to vouch the cash book.

5.6. Vouching the Debit side of cash book :

The following are the items appear on the debit side of the cash book.

1. Opening balance :

This should be compared with the balance shown in the duly audited balance sheet of the previous year. This is done to see that the actual balance has been brought down.

2. Cash sales :

There are greater chances of fraud under this head. The salesman may sell goods and may not make an entry in the cash book and thus misappropriate the money. The following system should be avoided to avoid fraud. The sales man should neither deliver the goods to the customers nor receive cash for the goods sold. At the end of the day the salesman, the cashier and the gate keeper prepare the summaries and send them to the general manager. All the three summaries must tally. The auditor should check here and there a few items from the sales man's summaries, cashier's summaries and the gate keepers extracts. If the auditor does not do so; he will be held liable for any fraud which remained undetected as was decided in the case of Pendel bury's Ltd. Vs Ellis Green & Co in 1936.

The auditor should also compare the dates on the cash memos and the cash book. If cash discount has been allowed on sales, he should see a uniform policy and rate of discount has been followed.

3. Receipts from Debtors :

The auditor should vouch cash received from debtors to whom goods has been sold on credit in the past. The only evidence available on account of this item is the counterfoils of the receipts issued to the debtors. But this evidence is not very reliable as less amount might have been inserted in the counter foils than what had actually been received from the customer. Another method of committing fraud is when cash is received say from 'A' no entry is made in the cash book. Later on when cash is received from 'B' the amount is recorded on the debit side of the cash book by crediting the account of 'A', again when money is received from 'C' the amount is credited to 'B' and so on.

The auditor should pay attention to the following in order to check such a fraud. He should check the cash book with the rough cash book and the counter foils of the paying in slips. Particular attention should be paid to discount allowed to customers. The method of granting discount should be enquired. In case a debt is written off as bad the auditor should enquire as to who is responsible to write off debts as bad. Where ever possible after taking permission from his clients a statement of accounts should be sent to the debtors to confirm the balances and also debtors be instructed to send letters of confirmation direct to the auditor

4. Income from interests Dividends etc :

Interest received on account of fixed deposits in the bank should be vouched with the bank pass book. Dividends received can be vouched with the counter foil of 'tops' of dividend warrants or the letter covering the cheque. Where dividend and interest are collected through bank, pass book must be verified. Care should be taken to adjust the outstanding interest. Interest received from any particular fund like providend fund should be credited to that fund and not to the revenue account. If the interest has been received on account of the loan granted. Agreement with the borrower should be inspected to ascertain the rate of interest.

5. Loans :

The receipt of loan should be vouched with the agreement with the ledger, He should see whether his client is entitled to raise loans. He should examine the rate of interest payable, the terms of repayment and the securities offered.

6. Rents Received:

The auditor should examine the lease deeds and agreements to ascertain the amount of rent payable, the due date and provision regarding the repairs etc., If receipts are issued to the tenents for the rent paid, the counterfoils of the receipts would be a good evidence. Particular attention should be paid towards rent outstanding. If the outstanding is heavy one, with the permission of the client the auditor should write to the tenents requesting them to confirm the amount of arrears of rent outstanding against their names and also, the auditor should get a list of unlet property duly signed by a responsible official.

7. Bills Receivable :

The auditor should examine the entries in the Bills Receivable Book. He must compare these items with the entries in the cash book for all the bills matured. In respect of those bills which have been discounted before maturity the Bills Discounted Book should be checked. He should also see that all the records have been properly made in the books related to discounts, dishonour or retirement of all bills.

8. Commission :

Commission account should be checked with the accounts of the parties from whom commission has been received. Agreement with the parties regarding the rate of commission should be inspected.

9. Sale of Investments :

The amount received on account of the sale of investments should be vouched with the brokers sold note.

10. Bad debts Dividend :

The amount received from debtors, who have become bankrupt should be vouched with the dividend warrants received from the official receiver indicating the total debt and rate per rupee payable as dividend and the number of instalments.

11. Subscriptions received by a club or school etc.; should be checked with the register of subscribers and the counter foils of the receipts.

12. Insurance claim money :

Insurance money received against a claim from an insurance company should be checked from correspondence passing between the client and Insurance company.

13. Sale of fixed assets :

This item may be vouched with correspondence auctioneers account, sale of contract etc. If there is any profit that should be credited to the capital reserve account which is not available for distribution to the shareholders. The auditor should also see that the sale of such property has been properly sanctioned.

14. Income from hire purchase agreement :

Where money is received on account of the instalment relating to goods sold on hire purchase system. The auditor should examine the agreement. The auditor must also see that proper allocation between sales and interest had been done.

8.7. Vouching of credit side of the cash book :

The auditor should see that the payments have been actually made to the right person or party and also whether the payment is for the business itself and have been sanctioned by a person holding some authority and have properly recorded in the books of account.

1) Payments to creditors :

Money paid to the creditors can be vouched with the receipts issued by the creditors acknowledging the receipt of money. The auditor should enquire whether periodical statements are submitted by the creditors and are compared with the creditors accounts. In regard to cash purchases, cash memos and goods inward book should be compared with the entries in the cash book.

2) Wages :

Another important entry which is usually a big one is that of wages. Before the auditor proceeds with his work, he should make a through investigation regarding the internal check system which is in operation. If he finds any loophole he should probe into it and disown his responsibility. He should check the casts of the wage sheets and wages book. He should check the total amount of wages payable with the amount of cheques drawn to see that more money has not been with drawn than was needed. He should check the names of some of the workers mentioned in the wages sheets with the cards and the gatekeepers and the foreman's register to see that no dummy workers are included. He should also see that the wages sheets are properly signed by all the persons responsible for the preparation of the wages sheets. The number of workers as recorded in the wages sheets should be compared with the employees state insurance cards. Wages sheets of the previous months should be compared with the current month and if there is any increase, enquiry must be made. He must compare the signatures of the workers of two or three periods. In short the duty of an auditor in verifying the items of wages sheets. The number of workers as recorded in the wages sheets should be compared with the employees state insurance cards. Wages sheets of the previous months should be compared with the current month and if there is any increase, enquiry must be made. He must compare the signatures of the workers of two or three periods. In short the duty of an auditor in verifying the items of wages is to see that the wages as recorded in the cash book have actually been paid and that they were actually due and that they were properly authorised.

3. Loans :

He should examine the receipt given by the borrower and the loan agreement, promote or Bills of exchange. He should make enquiry whether his client is authorised to advance loans. In case of loan to the directors, managing agents he must see that the provisions of the companies act are satisfied. (Sec 295, 369 & 370).

4. Salaries :

Salaries book should be examined. He should see that the total of the salaries book for a particular month agrees with the cheque drawn for salaries. He should see that necessary deductions for providend fund, Income tax etc have been made. Salaries may be verified with the annual returns submitted to the income tax Department regarding the payment of salaries.

5. Agents and Travellers Commission :

The agreement with travellers and the agents should be examined to ascertain the terms of the appointment regarding the rate of commission. The auditor should test the payment of commission by examining the order received through the travellers.

6. Travelling allowances :

He should see the rules and regulations regarding the payment of travelling allowances. Calculations should be made. An extraordinary travelling expenses should be authorised by the Board of Directors. Where fixed travelling expenses are allowed, no calculations are necessary. He should see that the travelling bills have been duly checked by a responsible official.

7. Insurance premium :

In case of a new policy, the covering note or the receipt from the Insurance company and the policy itself should be checked. In case of a renewal the renewal receipt for the premium should be examined.

8. Bills payable :

Returned bills duly cancelled should be examined. It would be a sufficient evidence of the amount having been paid.

9. Bills receivable discounted and dishonoured :

Bills Receivable which has been discounted with the bank and which have been dishonoured can be vouched with the entry in the bank pass book. The auditor should see that the account of the acceptor is debited with the amount of bill and noting charges.

10. Freight, carriages and customs duty :

The statements of account regarding the payment of freight and carriage submitted by the suppliers clearing forwarding agents should be examined to see that the payment has been duly made and accounted for.

11. Bank charges :

Bank Charges such as commission, interest on over draft and loans etc., should be examined with the Bank Pass Book.

12. Partners Drawings :

Partnership deed should be examined as to what is the maximum amount and the time for which a partner can draw money and whether he is to be charged any interest on drawings. He should vouch this entry with the partners drawings book or account and see that the signature of the partner is there against such entry.

13. Petty Cash :

There are greater chances of misappropriation of cash as there are no vouchers for a number of petty expenses. He should therefore make an enquiry into the internal check system of petty cash payments. The petty cash book should be maintained on the imprest system. He should insist upon having vouchers for every expenditure say above Rs.20 or so. In case where getting voucher is not possible then docket system should be introduced. The counting of petty cash balances in hand is very important. If he does not do so and if there is any discrepancy in the balance as per the petty cash book and actual cash in hand. He will be held responsible to pay damages as was held in the case of London oil storage Co. Vs Sear Hasluck & Co.

14. Directors Fees :

As a general rule the directors of a company can not claim any remuneration unless the Articles expressly provide for it. According to [See 211 (2)] of the companies Act, the remuneration paid to the directors either by way of fees or commission etc., must be shown separately in the profit & loss A/c. If this has not been done the auditor must make a mention of this fact in his report.

15. Vouching of cash sales :

At first the auditor has go through the system of Internal Check followed by the concern. If he satisfied with the system of internal check employed in the concern, the auditor should check here and there a few items from the sales man's summaries, cashiers summaries and the gate keeper's extracts. If the auditor does not do so, he will be held liable for any fraud which remained undetected as was decided in the case of Pendle Bury's Ltd Vs Ellis Green & Co in 1936. The auditor should compare the dates on the cash memos and the cash book. If discount has been allowed on sales he should see that a uniform policy and rate of discount has been followed. The cancelled cash memo should not be detached from the book. He may also compare a few items of sales with the stock register.

8.8. Vouching of Trading transactions :

After completing the vouching of cash book, the auditor may now proceed to the audit of the trading transactions.

Here the auditor is concerned with the checking of the purchases book and the sales book. The main object of vouching these two books is to check and prevent misappropriation of goods. The auditor should see that his client pays only for those goods which are received by him. Therefore, the auditor should carry out the audit of these books very carefully and intelligently.

8.9. Purchases Book – Purchases Returns book :

Purchases Book :

After having satisfied himself that there is a good internal check system regarding the purchases, the auditor should now proceed to vouch the purchases book. Entries in the purchases book should be vouched with the invoices relating to the purchases and the goods inward book maintained by the gate keeper and the godown keeper and the delivery note if any. He should see that the names of the creditors in the sales book has been entered in the purchases book.

While examining the invoices the auditor should pay attention to the following points.

1) Whether the invoice is in the name of his client.
2) Whether the person who ordered the goods is authorised to do so.
3) The date of the invoice should relate to the period under audit.
4) The auditor should also see that the goods mentioned in the invoice are not capital goods
5) He should, as a test check compare some invoices with the goods inward book in order to see that the goods have been actually received.
6) The auditor should check the casts and cross casts of the purchases book.
7) He should see that the trade discount has been deducted from the invoice before making the entry in the purchases book.
8) To inflate the profits, sometimes it is the practice of the management to include the goods purchased in the closing stock, while no entry was made in the books. In this connection he should pay particular attention to the purchases made at the close of the year to see that they are included both in the purchases book as well as in the stock book, otherwise he will be held liable to pay damages as was decided in the case of Smill Vs Offers and others.
9) The auditor should stamp the invoice or cancel it after he has compared it with the entries in the purchases book to prevent its being purchased again.
10) Sometimes the officials of the company purchase goods through the company in order to take advantages of the trade discount. In such a case he should see that the adjustment regarding this has been made in the books of accounts.
11) If any duplicate invoices are produced for verification, then the auditor should satisfy himself that the reasons for the presentation of duplicate invoices in the place of original one.
12) In order to be sure that all the invoices are included, the auditor should ask his client to write to all the creditors to send their statements of accounts direct to the auditor for comparing with ledger accounts.
13) If the invoice runs into several pages the auditor should see that the grand total is correct.

Purchases Returns :

When the goods are returned to the seller, being not according to the sample, a credit note should be obtained. The auditor should compare the credit note with the purchases returns book and the gate keepers outward book or the stores record. He should pay particular attention to heavy returns.

8.10. Sales Book – Sales Returns Book

First the auditor should see that the internal check system is efficient. If it is not so he should disown his responsibility. If it is efficient he should apply a few test checks.

He should compare the date of the copy of the invoice with the date in the sales book.

The entries in the sales book should be compared with the invoices, order Received book, Delivery note duly signed by the purchaser, receipts issued by the transport company or the Railways.

He should further see that the sale of an asset is treated as ordinary sale, otherwise profit will be inflated.

With the permission of the client the auditor should send statements of account to the customer's to confirm the accuracy of the balance in their accounts.

He should check the sales book for the last days or weeks of the financial period and the returns. Inward book for a few days or weeks after the close of the period in order to see whether fictitious sales or returns has been recorded to inflate profit.

7) He should check the casts of the sales book.

8) The cancelled invoices should be checked with the duplicate copy of the invoice.

9) Sales tax, Insurance charges etc; which are recoverable from the customers should be debited to the customers account.

10) Sales to allied concerns should be carefully examined as there may be fictitious entries with a view to inflate profits.

11) If there is a significant difference of trade discount allowed to two different purchasers he should inquire into the reason of such a distinction.

Sales Returns :

When the goods are returned from customers, they should be entered by the gate keeper in the register known as gate keeper in the register known as gate keepers Returns. Inward book and the stock register. The goods returned should also be recorded in the sales returns book and a credit note should be prepared to be sent to the customers. Such a credit note should be signed by a responsible official. The auditor should pay particular attention for this transaction as there is more scope for committing fraud under this head. If there is time lag between sale and return. The auditor should see whether the returned goods were in good condition. Returns from sister concern should be carefully examined to see their genuineness.

The auditor should vouch these transactions with the gatekeepers Returns Inward Book and with the carbon copies of the credit notes sent to the customers or the debit note received from the customers.

8.11. Summary :

Examining the documentary evidence of the transactions appearing in the books is known as 'vouching'. It is the essense of auditing. A voucher is a documentary evidence of a transaction which may be a carbon copy, a receipt or a contract. Before starting the work of vouching the auditor must himself satisfy with the system of Internal check employed by the concern. After vouching the cash book both sides of receipts and payments, he should vouch the trading transactions.

8.12. Model questions

1) How do you vouch the receipts side of cash book ?

2) What is the voucher ? What do you understand by the term 'vouching' in Audit.

3) How would you vouch the following ?

   1) Income from investments.

   2) Petty cash payments.

   3) Travelling expenses.

4) What do you mean by 'vouching' ? What are the points an auditor should look into when examining vouchers ?

5) How can you vouch wages ?

6) How will you vouch a Sales Book and a Sales Returns Book ?

7) Explain the points you would keep in view while auditing the sales.

8) Discuss the steps that should be taken by an auditor in vouching credit purchases and purchases returns.

8.13. Reference books

Principles of Auditing	**:**	**R.G. Saxene**
Principles & Practices of Auditing	**:**	**B.N. Tandon**
Principles & Practices of Auditing	**:**	**Jegadish Prakash**
Contemporary Auditing	**:**	**Kamal Gupta**

- Dr. Ch. Suravinda

Lesson - 9

VERIFICATION AND VALUATION OF ASSETS

9.0 OBJECTIVES

After studying this lesson you should be able to understand the following concepts.

* How to verify the assets
* How to value the assets

Structure

9.1 INTRODUCTION

One of the important duties of an auditor in connection with audit of the accounts of a concern is to verify the assets and liabilities appearing in the Balance Sheet of a Business concerns. Verification means 'proving the truth'or confirmation. He has not only to examine the arithmetical accuracy and bonafide of the transactions in the books of account by vouching only. But he has also to examine that the assets as recorded in the Balance Sheet actually exist. He also see whether a particular asset as recorded in the Balance Sheet on the day of the closing of the books of account exists or not. The accuracy and profits depand upon the correct valuation of assets. According to accepted principles assets are generally classified into fixed assets, and floating assets. The procedure of verification changes according to the nature of assets.

9.2 VERIFICATION

The examination of the books of account with a view to ascertain their arithmetical accuracy is not enough. The auditor must verify that the various items appearing in Balance Sheet are in the possession of the concern under audit.

Verification is a process by which the auditor satisfies himself, by actual inspection or otherwise, as to the existence, ownership, valuation and accuracy of the various items appearing in the balance sheet.

Spicer and Pegler have defined verification in the following words: "The verification of assets implies on enquiry into the value, ownership and title; existence and possession, the presence of any charge on the assets".

In the words of Lan caster, "the verification of assets is a process by which the auditor substantiates the accuracy of the right hand side of the balance sheet and must be considered as having three distinct objects -

a) The verification of the existing assets

b) The valuation of assets

c) The authority their acquisition.

Advantages of Verification of Assets

Careful verification of assets will fetch the following advantages to the client of the auditor.

1. Avoidance of manipulation and embezzlement.
2. Guard against improper use of assets.
3. Proper recording and valuation of assets.
4. A true and fair position of the business shown by the balance sheet.

The verification of assets involves the following stages.

1. Comparing the ledger accounts with the balance sheet.
2. Verifying the existence of the assets on the date of the balance sheet.
3. Satisfying that they are free from any charge or mortgage.
4. Verifying their proper value.
5. Assets were acquired for the business and are clearly state in the balance sheet.
6. There are in the possession of the client or persons authorised by them.

9.3 VALUATION - DEFINITION

The valuation and its basis will differ according to the type of assets and the purpose for which they are held. 'However, he can always apply certain tests to find out the value of the assets.

According to Lancaster "An Auditor is not a valuer and cannot be expected to act as such. All that he can do is to verify the original cost price and to ascertain as far as possible that the current values are fair and reasonable and are in accordance with the accepted commercial principles".

9.4 ROLE OF THE AUDITOR IN THE VALUATION OF ASSETS

Auditor plays an important role in the verification and valuation of assets. The acuracy of the balance sheet and the estimated profits of a concern depend upon the correct valuation of the assets. Following points indicate the role played by the Auditor while valuation of assets.

1. The object of the valuation of assets is to show that the balance sheet represents a true and fair view of the state of affairs of the concern and that there is no manipulation of accounts to inflate the profits.

2. The auditor has simply to apply certain tests regarding the valuation of the assets.

3. He is to enlite to rely upon the certificates of competent persons such as valuers, surveyors, etc.

4. He should refer to the invoices to findout the price at which such assets were acquired.

5. Auditor should consider whether the assets are valued at replacement or reliable value.

6. The auditor has simply to apply the accepted principles of valuation.

7. If he is not satisfied with the mode of valuation, he must mention that fact in his report.

8. He should prove that the assets are not to be valued for the purpose of balance sheet at their break up values as if the business was closed.

9. The auditor while valuation of assets should take into consideration their original cost, the probable working life of the assets, the wear and tear of the assets, break-up value of the assets, and the chances of the assets becoming obsolete, to see that the basis of valuation and the calculations are correct and that all contingencies are provided for.

10. In the cae of assets like cash, bills receivable and investments an inspection should be made by the auditor personally on the date of the balance sheet.

11. If there are several cash balances or a large number of investments, the auditor should verify all of them at the same time to avoid the possibilities of substitution.

12. In case it is not possible to check all of them in one sitting, he must keep all the securities and cash balances under his control and possession until he has completed his verification.

9.5 ADVANTAGES OF VALUATION OF ASSETS

Valuation of assets is an important part of verification.

1. The true and fair view of profit and loss account and balance sheet depend on the correct valuation of assets.

2. Over valuation or under valuation of assets may not possible with strick valualtion of assets.

3. even though the auditor is not an expert, he must be cautious and painstaking in verifying the values of the assets at which are shown in the books.

9.6 VERIFICATION AND VALUATION OF ASSETS

For verification and valuation of different assets, we can classify assets into the following groups -

1. Fixed assets.
2. Intangibel assets.
3. Floating assets
4. Fictitious assets.

9.6.1 Fixed Assets

Fixed assets are puchased for permanent use in the busines. The hole business is carried on with the help of these assets. Fixed assets are usually valued at the going concern value, i.e., cost price less depreciation.

While verifying the fixed assets an auditor must satisfy himself with regard to the following points.

1. See that the record of the fixed assets has been maintained in a proper manner and the complete inventory of all the fixed assets is available.
2. See that the fixed assets bear proper marks of identification.
3. See that the management planned detailed procedure regarding frequency and coverage for the physical verification of fixed assets by competent perosns, preferably having some technical background.
4. See whether all fixed assets are verified periodically and regularly and the physical existence is reconciled with records. In case of discrepancies, if any, what actions have been taken?
5. See that there is a written procedure for the verification of fixed assets.
6. See that verification is usually carried out by those who are familiar with the assets.
7. Check the procedure for the verification of fixed assets in the possession of their parties.
8. Check whether the reports of internal verification of fixed assets indicate any damanged or obsolete assets.
9. Check whether the fixed assets are properly insured. has there been any claim during the year? If so, how has it been dealt with in the accounts?
10. See that the fixed assets have been properly valued after depreciation and disclosed in the Balance Sheet according to the requirement of Scheduled VI of the Companies Act.
11. See that a proper system of authorisation and approval regarding the acquisition and disposal or replacement of fixed assets is followed in the organisation.
12. See that the documentary evidence has been checked to ensure actual receipts of the purchased assets and the supplier's invoices have been traced into fixed assets records.

(1) Plant & Machinery

In case the machines are purchased in the current accounting period the invoices and the agreement with the vendors should be verified. If the machinery was existing in the previous accounting period, the auditor should examine the schedules of plant and machinery prepared and certified by the engineer incharge to ascertain the capital outlay. In case where additions have been made to the machine, the auditor should vouch these additions and see that they are shown distinctly. Expenses incurred on custom duty, freight and erection of machine etc., must be debited to Machinery Account. Any expenditure on repairs and renewals should be charged ot Revenue Account.

If the Plant Register is maintained, he should inspect this Register to ascertain that depreciation on machinery is adequate or not and the working life of the machine has been correctly estimated.

He should prepare a list of each machine from the Plant Register and should get the list certified by the works manager. Since he is not a technical man he has to depend upon the advice of the works manager regarding their valuation and the depreciation charged on each machine.

He should see that Plant and Machinery Account is shown in the Balance Sheet at cost less depreciation after making proper adjustment regarding purchases of machinery and sale of some parts effected during the year under audit.

In case machines are in a foreign branch the auditor should obtain certificates from the professional verifiers in the foreign country.

If any plant and machinery has been scrapped, destroyed or sold, the auditor should ascertain that the profit or loss arising. Thereon has been correctly determined. He should obtain a certificate from a senior officer that this has been done.

(2) Furniture

The auditor should examine the invoices of the dealers in case the assets have been acquired during the current accounting period. Any expense incurred in the purchase of the asset should be debited to the Furniture Account. The addition made during the period should be examined in the usual manner. Repairs to furniture during the current year should be debited to revenue account. For the assets existing during the previous accounting period the values should be verified from the schedule of assets of the previous accounting period. The auditor should enquire into the methods of charging depreciation. He should see that whenever a piece of furniture is purchased it must be properly recorded in the stock register and numbered to avoid any kind of pilferge.

(3) Property

The auditor should verify this item in detail and for this purpose he should distinguish between the freehold property and the leasehold property.

(a) Freehold Property : Where freehold property has been purchased, he should examine the title deeds e.g. the purchase deed, the certificate of registration, the broker's note and the auctioneer's account etc. in order to verify the correct position. As regards the purchase price of the freehold property, he should refer to the statement of purchase received from the client's solicitors. He should see that the property is in the name of the client. He should also see that the conveyance deed has been registered in accordance with the Indian Registration Act.

In case where the property has been mortgaged. The auditor should obtain a certificate from the mortgagee regarding the possession of title deed and the outstanding amount of loan. In case the property is rented out, he should exmaine the receipt of the rent particualarly the receipt of the last rent collected.

If the property has been acquired in the current year the cost may be verified with the help of the bank pass book. He should also vouch all the payments made in this connection.

He should also see that a separate account for building and land on which it is constructed is maintained. It is necessary because depreciation is provided for building and not for the land.

(b) Leasehold Property : In the case of a leasehold property the auditor should take the following steps to verify this asset.

He should examine the lease contract to find out value and duration. A lease exceeding one year is not valid unless it has been granted by a registered instrument (Section 107 of the Transfer of Property Act). He should see that the terms and conditions of lease are properly complied with. He should also examine the last receipt of the payment of lease rent. In case the property is sub-let he should examine the tenant's agreement.

He should see that depreciation is duly provided for the value of the lease and for this purpose the original value of the lease mut be examined.

Property which is in the process of construction but has been shown in the balance sheet, the auditor should check the following points:

1. He should examine the certificate of the architect for the completed works. He should see that only the completed works are included under this heading in the balance sheet.

2. He should see that the allocation between revenue and capital expenditur is made correctly. This is very important where the construction is being undertaken by the staff of the client.

3. He should obtain a certificate from a responsible officer about the capital expenditure incurred.

(4) Loose Tools, Patterns, Dies etc.

Such assets have short useful life and the value per unit is also low. Hence no separate accunt is maintained for each unit.

1. The auditor should examines the list of the loose tools.

2. The auditor should see that the list has been certified by a responsible officer.

3. This type of assets comprises items like small tools, dies jigs, moulds etc. Some of them are liable to be lost and same of them consumed very rapidly. Hence the conventional method of depreciation is not applied to them. "Montgomery" suggests "charging the cost of replacement of such items to maintain in lieu of depreciating them is usually a satisfactory alternative'.

4. Where the company makes its own tools, the auditor should see that they are not valued in excess of the cost.

Investments

1. Schedule : If there are a large number of investments, as in the case of banks and insurance companies, the auditor should ask for a schedule of investments held by his client. The schedule should disclose full particulars of the investments, e.g. name of the investment, the cost price, the market price, book value, date on which the investment was acquired, rate of interest payable and the dates of the payments of interest, tax deducted and so on and compare these with the records in the books of his client.

2. Transfer Deed : In the case of purchase of stocks and shares for which no certificate has been issued till the date of verification, the transfer deed will be a good evidence for the purpose. when new shares have been applied for, the receipt for the application money or the allotment letter should be examined.

3. Comparison: (a) The auditor should examine all the investments simultaneously and compare them with the schedule. If the number of the investments is large and they cannot be inspected at one sitting, the investments which have been checked must be locked and sealed in a box so that they may not be produced again at the time of the next inspection.

(b) Where these investments are held by any trustee on behalf of the company, the trust deed executed by such a nominee should be examined. In the absence of a trust deed, he should get a certificate from the trustee that the latter holds those securities in trust and that they are free from any charge, and that they are in favour of the nominee or any other person.

(c) If the securities have been entrusted to the bankers for safe custody, the auditor should get a certificate from the bank regarding the number of securities held by it for safe custody and to check that they are free any charge.

Land

The verification procedure for land can be as under:

1. Land is not consumed in the course of business, hence it is not subject to depreciation. Thus the auditor should see that land is shown in the Balance Sheet at original cost basis. The method of valuation is the same whether it is freehold land or leasehold land.

The auditor can check the cost with reference to the original purchase contract. He should also see the minutes of the Board of Directors authorising the purchase.

2. The auditor should see that land is not subject to any charge or mortgage, etc.

3. The auditor is not competent to check the title deeds, the purchaser's note etc. Therefore, he should get a certificate regarding their validity from the solicitor.

4. Cost of land will be increased if the following expenses are incurred - broker's commission, title examination fees, improvement expenses, etc.

Where the land has been given on rent by the client, the auditor should examine the agreement and other relevant date. He should also check that the ground rent receivable has been properly accounted for.

Motor Lorries and Vans

1. Where the number of vehicles owned is large, it is desirable that a register, like the Plant Register, be maintained for them. Such a register may be called the Vehicles Register. The auditor should obtain a schedule of all motor vehicles owned by the company together with the registration books and insurance policies.

2. The Auditor should also go through the log book and carry out physical inspection of the vehicles. The auditor should examine the Registration Book for each vehicle. While comparing it with the ledger account of the Vehicle Register, road tax and insurance premium receipts should be examined.

3. On examination, if it is found that some vehicles are not registered in the client's name he must ascertain the reasons for this and obtain a written confirmation from the person named in the registration book that the vehicle is the property of the client and that no charge is claimed thereupon.

4. Where the original cost of these assets is appreciably high there will be heavy wear and tear. In such cases, the auditor should ensure that the rate of annual depreciation applied is adequate. All additions during the year should be carefully scrutinised to ascertin that only actual additions by way of new acquisitions are capitalised, and that repairs and replacements have been charged off to revenue.

9.6.2 Intangible Assets (Wasting Assets)

Any asset having no concrete form and not capable of being perceived especially by the sense of touch is an intangible asset. But it is no less useful for the business and is also realisable in cash. Goodwill, patents, copyrights trade marks, etc. are examples of intangible assets.

Goodwill is a fixed asset of a peculiar nature. It is an intangible asset and its value depends upon the earning capacity of the business. Goodwill is normally shown as an asset in the Balance Sheet when:

1. The amount paid for the purchase of a business has been in excess of its net assets,
2. The company has made revaluation of its assets and raised a goodwill account in its books,
3. Goodwill once written off is later brought back in the books to write off the debit balance of the Profit and Loss Account or capital losses that the company might have suffered,
4. Heavy expenditure is incurred in introducing a new product in the market or in rendering service to the customers,
5. The Company has established a special reputation in the market because of its increasing sales and profits.

   1. Goodwill
   2. Patents
   3. Copyright
   4. Trade Marks
   5. Preliminary Expenses

Verification Procedure :

1. If goodwill is shown in the books of account, the auditor should verify it by referring to the contract with the vendors to find its value.

2. If goodwill has been purchased as an asset, the vendors' agreement and the resolution of the Board of Directors would provide the auditor with sufficient evidence. he should see that the sum paid for goodwill does not exceed the difference between the total purchase consideration and the value of the net tangible assets acquired.

3. The auditor should see that regular revenue expenditure is not capitalised. Deferred goodwill must be clearly shown in the Balance sheet to differentiate it from the 'purchased goodwill'. The auditor should see that such a goodwill is written off within a reasonable time.

4. The auditor should see that the goodwill is shown separately in the Balance Sheet stating its valuation method clearly.

5. Where goodwill has become fictitious becuase of continued heavy losses or sale of major part of the undertaking, the auditor should advise his client to write off the amount of goodwill so that the financial accounts disclose true and fair poistion of the business.

Patents

The audit procedure regarding patents is as follows:

1. The auditor should insist upon his client to supply him a list giving the description of each patent, their registered number, date, and number of years to run.

2. He should check the certificate of grant of patent or the assignment of the interest in it and should also verify the cost and any subsequent expenditure of futher protection of it.

3. He should see that renewal fees has been charged to revenue.

4. The cost of patent should be written off in the course of its life. The auditor should see that this is being done.

5. Sometimes a patent might become valueless due to obsolescence or failure to create a demand of the patented article. In such a case, the auditor should see that its value is written off even before expiry of the period covered by the patent.

Copyrights

The verification procedure of an item under this heading in a Balance Sheet will be on lines similar to those just described in the case of patents. The best method of dealing with copyrights is to revalue these at the end of each financial year. Where any pub lication ceases to command sales, the copyright in respect thereof losses its value, and the cost of publication of such work should, therefore, be written off as a loss.

Trade Marks

The auditor should verify the Trade Marks by examining the assignment deed duly endorsed by the office of the Registrar of trade-marks. It should be seen that the trade marks are registered in the name of the client and are his property. he should also vouch the payment in case the trade-marks has been purchased. The renewal payment reciepts must also vouched. he should see that any expenditure incurred in the acquisition of the trade-mark has been treated a s a cpaital expenditure. All research expenses in this connection should also be capitalised. The effect of obsolescence on the trade-mark should also be noted. Trade-marks should be disclosed in the Balance Sheet at the original cost less depreciation.

Preliminary Expenses

Although these items appear on the assets side of the Balance Sheet, they are in fact revenue expenditures which are for the time being “held up”. The Companies Act allows these to be shown on the assets side of the Balance Sheet until written off, but as they do not represent any tangible values, it is better that they are written off earlier.

The auditor should ensure that commission paid on shares and the preliminary expenses paid do not exceed the limits laid down in the Comapanies Act. The writing off procedure given in the Act should also be followed in this connection.

9.6.3 Floating or Current Assets

Floating assets are those assets in which the form deals in normal operation of the business. Such assets are subject to constant changes and rotation. They are convertible into cash within a relatively short period of time. Floating assets include the circulating or liquid assets or current assets, the examples being stock in trade, cash, bills receivable, debtors, short-term securities and pre-payments.

Book Debts

One of the very important duty of the auditor in connection with verification of debtors is to see that the debts as shown in the Balance Sheet are recoverable. If they are doubtful, adequate provision has to be made for them. When they are bad, i.e. they are irrecoverable, they are not shown on the assets side. Where the auditor does not pay any attention to these points, the Balance Sheet which he certifies to show a “true and fair view” may be wrong and he might be held liable for damages.

Thus, the objective of verification of debtors is to establish : (i) its accuracy (ii) its validity as claims agianst the recorded debtors, (iii) its collectibility and determination of its realisable value, and (iv) its fair disclosure in the financial statements in accordance with legal provisions. Verification of debtors balances should be carried out by employing the following procedures:

1. Year-end scrutiny and checking of balances

2. Test checking of subsequent recoveries

3. Direct Confirmation Procedure

Direct confirmation of balance from the debtors is the best evidence in suppport of outstanding balances. But such confirmations are not always avaialbel and it should be remembered that such confirmations will not being to light suppressed debtors balances, resulting from the suppression of sales.

The institute of Chatered Accountants of India through its Statement on Auditing Practices recommends that the direct confirmation of balances should be based on the following:

1. Confirmatory letters should be obtained from the debtors directly by the auditor. Arrangements should be made with the client for sending out these letters to the debtors.

2. The auditor should see that the debtors' ledger trail balance is extended by clients and agreed with the control account, if any. Where the number of debtors is small, all of them may be circulated, but if they are numerous this could be done on a test basis. The auditor should ensure that the method of selection of the customers to be circularised is not revealed to the client until the debtors ledger trail balance is handed over to the auditor. A list of debtors selected for confirmation should be prepared in duplicate and a copy handed over to the clients for preparing requests for confirmation which should be properly and fully addressed.

3. The auditor should see that client's staff is not given an opportunity to prevent despatch of the confirmatory letters to any particular debtors.

Loans and Advance

The verification procedure for loans and advances is almost the same as for debtors. The additional points for verification of this item are as follows.

1. The auditor should pay special attention to the sanctioning of loans by the Board of Directors.

2. If there are any debtors for loans granted by the company, the auditor should see that the amount of such loans is not included in the list of sundry debtors but is shown separately.

3. Where such loans are secured, he should inspect the securities and obtain letters from the debtors acknowledging the amounts owned by them on the date of Balance sheet. Where the loans are unsecured, the auditor should enquire if the amunt is recoverable in full.

4. The auditor should examine all the documents relating to the loan and satisfy himself that the borrower is competent to receive the loan.

5. Where loans are owned by the directors or other officers of the company, it should be seen that a clear statement to that effect is made on the face of the Balance Sheet.

6. The auditor should further satisfy himself that loans, advances or deposits made by the company are within the powers of the company as laid down in its Memorandum and Articles of Association.

7. As far as loans to companies are concerned, the auditor should specifically note that the provisions of the Sec.370 are complied with.

Loans of Employees : Sometimes loans are made by firms and companies to their employees to assit them to purchase houses or meet other occasional expenditure. In such caes the loan agreements or other documents signed by the employees acknowledging such loans must be inspected and the terms in respect of interest, if any, and repayment noted.

a. Loans given to bodies corporate, not under the same management should not exceed 10% of the capital and free reserve of the lending company.

b. Where loans are in excess of the above limit the prior approval by special resolution of members of the company has been obtained. In case the loans made to the bodies corporate exceed (i) 20% of the capital and free reserves of the lending company (where the borrowing and lending companies are under the same management) and (ii) 30% of the capital and free reserves (where the companies are not under the same management), in addition to the special resolution, approval of the central government must have been obtained.

Verification of Bills Receivable : The audit procedure for bills receivable are as follows :

1. The auditor should compare the schedule of bills in hand at the date of the Balance sheet with the Bills Receivable Book.

2. Bills on hand should be verified by actual inspection of the bills, care should be taken to see that no overdue bills are included.

3. If any bills have been met subsequent to the period but prior to the date of audit, the same should be traced through the Cash Book.

4. If the bills are lodged with the bankers for collection, a certificate should be obtained from the bank stating the bills on hand at the date of the Balance Sheet.

5. In regard to bills that have been discounted or endorsed away and remain unmatured on the date of audit, the auditor should ensure that the contingent liability in respect thereof has been shown at the foot of the Balance Sheet and a proper reserve has been made in regard to overdue bills.

Verification of Investments in Subsidiary Companies : The auditor should ensure that dividends received after acquisition of controlling interests, if paid out of pre-acquisition profits, are credited against the cost of the shares, thereby reducing their value, as the holding company has since received part of the value which it originally purchased.

Advance Payments : The three major objectives for verification of this item are (a) to establishe the validity of the expenditure originally debited to an asset account, (b) to determine that definite benefits will be received in future periods from any unexpired cost being carried forward as an asset, and (c) to determine the reasonableness of amortisation programme being applied to such an asset.

9.6.4 Fictitious Assets

An asset which, like an intangible asset, does not have a concrete form but which, unlike it, is not realisable in cash, is a fictitious asset. In fact, fictitious asset represents capitalisation of expenditure which is essentially of a capital natue and the benefit thereof is expected to be available in future years. Preliminary expenses, special advertising expenses, expenses on issue of debentures and discount thereon, and development expenses, are examples of fictitious assets.

Although these items appear on the assets side of the Balance Sheet, they are in fact revenue expenditures which are for the time being "held up". The Companies Act allows these to be shown on the assets side of the Balance Sheet until written off, but as they do not represent any tangible values, it is better that they are written off earlier.

The auditor should ensure that commission paid on shares and the preliminary expenses paid do not exceed the limits laid down in the Comapanies Act. The writing off procedure given in the Act should also be followed in this connection.

9.6.5 Verification of Some typical assets

Assets Acquired on Hire Purchase

Legally in such assets ownership does not vest in the company. But such assets should be recorded at their cash value. Where it is not redily available, it should be calculated by assuming an appropriate rate of interest. They should be shown on the Balance Sheet with an appropriate narration to indicate that the company does not have full ownership.

Jointly Owned Assets

In case a company owns assets jointly with others(Other than as a partner in a firm), the auditor should see the extent of the company's share in such assets and its proportion of the original cost, accumulated depreciation and written down value have been stated in the Balance Sheet. Alternatively, he can check that the pro rata cost of such jointly owned assets has been grouped together with similar fully owned assets. He should also ensure that details of such jointly onwned assets are indicated separately in the fixed assets register.

Purchases in Lot

When several assets are purchased for a consolidated price, the auditor should see that consideration has been apportioned to the various assets in the ratio of their respective market values on the date of purchase as assessed by expert valuers in addition to the other considerations discussed above.

Figure Showing Classification of Fixed Assets

Assets

- **Fixed Assets**
- Plant & Machinery
- Investment Land
- Land & Building (Property)
- Furniture & Fitting
- Motor Lorries & Vans

Intangible Assets

- Good Will
- Patents
- Copyrights
- Trade Marks

Floating Assets

- Cash
- Stock
- Book Debts
- Loand & Advances
- **Loand to employees**
- Bills Receivables
- Investment
- Advance Payments

Fictitious Assets

- Preminary Expenses
- Special Advert., Exp.,
- Expenses on issue of Debentures
- Development Expenses

Typical Assets

- Assets acquired on Hire Purchase
- Jointly Owned Assets
- Purchase in lot

9.7 SUMMARY

Thus auditor verify and value each and every asset. He has not only verify the accuracy of accounts and bonafide of the accounts and accounts see that the assets recorded are in existence. Assets are divided into fixed assets, floating assets, intangible or wasting assets, fictitious assets, typical assets. Fixed assets should be valued at cost price less depreciation. Floating assets are valued at the date of the balance sheet at original or historical cost price or the market price whichever is the lower. Intangible assets should be shown at cost price.

9.8 GLOSSARY

Replacement Value : It is the amount which would be required to purchase another asset of the same type to replace the existing one.

Realisable Value : It is the amount which the existing asset would fetch it is sold in the open market.

9.9 SELF ASSESSMENT QUESTIONS

Five Marks Questions

1. Define the term Verification.
2. What is meant by Valuation.
3. What is the role of Auditor in Verification and Valuation of Assets.
4. Advantages of Valuation of Assets.
5. How to value and verify Plant and Machinery.

Ten Marks Questions

1. Explain the terms valuation and verification.
2. How to verify and value cash.
3. What is the procedure to verify typical assets.
4. How to verify Fictitious assets.
5. How to verify Property assets.

Twenty Marks Questions

1. Briefly explain Verification and Valuation of different types of Assets.
2. Explain Valuation and Verification of Fixed Assets.
3. Explain Valuation and Verification of Floating Assets.
4. Explain Valuation and Verification of Intangible Assets.

9.10 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr.K.Kanaka Durga

Lesson - 10

Verification and Valuation of Liabilities

10.0 OBJECTIVES

After studying this lesson you should be able to understand -

→ Verification of Libailities

→ Valuation of Liabilities

Structure

10.1 INTRODUCTION

Verification means proving the truth or confirmation. One of the important duties of an auditor in connection with the audit of the accounts of a concern is to verify the assets and liabilities appearing in the balance sheet. He has not only to examine the arithmetical accurancy but he has also to see that the assets as recorded in the balance sheet actually exist. The fact that there is an entry regarding the liability and which entry has been found to be correctly recorded, is not a proof that the liability is in the possesson of the concern at the date of the Balance Sheet.

10.2 VERIFICATION OF LIABILITIES

The Auditor has to verify all the items appearing in the liabilities side of Balance Sheet. If the liabilities are overstated or understated in the Balance Sheet then it will not represent a true and fair veiw of the state of affairs of the company. Similarly the Profit and Loss account will be incorrect and they have not been entered in the books of accounts, it will show more profit and the balance sheet will not show such liability (Westminister Road Construction and Engineering Company).

The auditor, besides verifying the liabilities as shown in the Balance Sheet should also get a certificate from the management that all the liabilities for business purchases as well as for expenses or on any other account have been included in the books of account and that the contingent liabilities have been shown by way of footnotes to the Balance Sheet or have been provided for.

As regards the liabilities, the auditor has to satisfy himself with respect to the following points:

1. that the credit balances appearing in the books are really liabilities;

2. that liabilities not recorded whether by accident or design are brought into books;

3. that they are properly valued;

4. that they are properly classified and disclosed.

5. The Liabilities shown in the balance sheet are actually payable.

6. The recorded liabilities are payable for the legitimate operations of the business.

7. In case of liabilities created by some charge, the nature and extent of such charge has been disclosed.

8. The nature and extent of contingent liabilities has been disclosed in the Balance Sheet.

10.3 VERIFICATION AND VALUATION OF LIABILITIES

The items appearing on the liabilities side of the Balance Sheet and requiring verfiication can be grouped under the following four headings.

- Capital or Owners equity
- Reserves - Capital and Revenue
- Loan Capital
- Liability and Provisions

The verification of liabilities is much easier than their valuation. Different items on the liability side of the balance are to be verified and valued.

CAPITAL

Although Capital is not the liability of a Company, still it should be verified to enable an auditor to give a certificate in regard to the correctness of the balance sheet. Capital is verified in the following way.

a) **In the case of a partnership firm**: While auditing the partners capital, the auditor should first of all examine the partnership agreement. He must find out the original cpaital contributed by the partners, the rate of interest payable on cpaital, the amount of drawings allowed to be withdrawn, the rate payable on capital, salary payable to the partners and whether it will be taken away by the partners or not and so on. The auditor will see that capital accounts have been correctly maintained. He should calculate the interest on drawings and capital.

b) **In the case of a Company**: Viewing from the point of view of the going concern principle, capital is not the liability of a concern. But the auditor must verify its correctness so that he can report on the corretness of the Balance Sheet.

With regard to audit of a company's capital, the duties of the auditor can be put into two categories: (i) At the time of first audit, and (ii) at the time of subseqent audit.

Duties of the Auditor on First Audit : The duties at the time of first audit in brief are the following:

1. He should read the different clauses of Memorandum and Articles of Association of a company so as to note the authorised capital of the company.

2. The auditor should go through the Cash Book, Pass Book, Minute Book of the Board of Directors to know: (i) the number and the different classes of shares issued, (ii) the amount received on each share, and (iii) any balance due from the shareholders in respect of calls.

3. Where some of the shares have been issued for consideration other than cash to vendors, he should examine the vairous clauses of the contract between vendor and the company.

Duties of the Auditor on Subsequent Audit: Regarding the subsequent audit the duties of the auditor are to see that the share capital is same as at the end of the last year. Where he finds that the capital stands altered by isue of fresh shares etc., he should ensure that the relevant provisions of the Companies Act have been complied with.

DEBENTURES

A debenture is a written acknowledgement under the seal of the company for a debt due by the company undertaking to pay the debt and interest on debt. Debentures can be of various types.

Procedure for auditing debentures is briefed as under :

1. The auditor must very carefully ascertain the company's borrowing powers. Whether a company has power to borrow or not depends upon its objects, and the auditor must refer to the Memorandum and Articles for this purpose. A power to borrow, however, need not be expressed. It may be implied, and all trading companies have an implied power to borrow, as the same is regarded as incidental to the carrying on of their business. If there is any limit placed on the borrowing powers of the directors or the managing agents, the auditor should see that such limit is not exceeded.

2. See that all the requirements of the Act in connection with loans on mortgage are rigidly carried out.

3. See that the assets mortgaged or charged are clearly indicated in the Balance Sheet.

4. See that where debentures are issued at a premium, the premium has been used towards reduction or writing off of goodwill or other fixed assets, or has been credited in the Debentures Redemption Fund or in the Capital Reserve Fund.

5. See that where debentures are issued at a discount and are repayable at par, the total amount of liability represented by the face value of the debentures has been shown on the liabilities side. The Discount on Issue of Debentures, being a loss, has to be written off during the term of the debentures, the unwritten balance being shown on the assets side for the mean time.

6. See that where debentures have been issued at par and are repayable at a premium has been provided proportionately out of the profits each year.

7. The auditor should ensure that the terms of issue of the debentures have been complied with.

Loans secured and unsecured

While verifying loans the auditor has the following duties:

1. Check the existence of the loans which he may do with reference to the agreement and correspondence for getting the loans.

2. Check payments on account of interest on laons, where any interest due has not been paid, the auditor should see that it is shown as a liability.

3. Call for confirmation letters from the parties who have advanced the loans. the auditor should seek information not only about the amount of the loan but also about the interest due and the security offered.

4. Check the power of the company to borrow with reference to the Memorandum and Articles of Association and the Companies Act.

5. Ensure that where any properties have been mortgaged by the company, mortgage has been registered with the Registrar of Companies and an entry has been made in the Register of Mortgages.

Liabilities and Provisions

1. The copy of application executed for obtaining the loan should be examined to ascertain the terms and conditions of the loan.

2. If any security has been provided for it, by creating a charge on some asset, the auditor should examine the agreement concerning the creation of the charge and this fact must be disclosed in the Balance Sheet.

3. The borrowing powers of the client must be verified and it must be ensured that loan was raised under proper authority.

4. The amount of interest accrued till the balance sheet date should either be paid or provided for. the auditor must see that this has been done.

6. In case of bank overdraft, he should examine:

   the agreement with the bank,

   the Bank Pass-book, and

   the statement of mortgaged assets.

Trade Creditors

1. The auditor should obtain a certified schedule of creditors from the client and check it with the individual creditor's account in the purchases ledger. Particularly to ensure that all purchases, including those made at the year-end, have been included in the purchases and duly credited to the accounts of the creditors concerned.

Further, the Purchase Ledger should be checked with the books of original entry, invoices, credit notes, etc.

As was held in Westminster Road Construction & Engineering Co. Ltd., the auditor has a duty to determine unrecorded liability in respect of goods received prior to the period under audit which, though included in stock, do not have a corresponding entry under liabilities.

2. The auditor should send confirmation requests to a select number of creditors concerning the balances standing as at the end of the year.

3. If any debt is found unpaid for a long time, enquiry should be made since it is possibel that instead of paying the creditor, the amount might have been misappropriated.

Amount Receivable in Advance

As far as amounts received in advance are concerned, to verify such amount the auditor should obtain a certified schedule thereof from the company or organisation. Not only this, he should further ensure that the entire amount so received has been shown as a liability in the Balance Sheet.

Outstanding Expenses

For verification of outstanding expenses the auditor should obtain a certificate from a responsible official to the effect that all outstanding expenses have been included in the current year's accounts. The examples of such expenses which should be debited to the current year may be apparent, e.g. rent of twelth month, or salaries payable or electricity charges for the last month, etc. Further, he should check entries for some weeks after the Balance Sheet date to ensure that they are not related to the year under audit. He should also ensure that outstanding expenses have subsequently been paid.

Bills Payable

The various steps involved for verification of bills payable are given below :

1. He should obtain a schedule of bills payable and compare the same with the Bills Payabla Book and Bills Payable Account.
2. The Bills that have already been paid should be cerified with the Cash Book.
3. To ensure that no fictitious bills have been included, he should examine the Cash-Book of the succeeding year to see that the payment has been made in respect thereof. In case any soul play is suspected, he should seek direct confirmation from the drawers of the bills.
4. He should also note that where any charge has been created on any asset of the concern by accepting the bill, note to this effect has been stated in the Balance Sheet.

Contingent Liabilities

There may be certain liabilities which may or may not arise after the preparation of the Balance Sheet. Such liabilities are called contingent liabilities.

The duties of the auditor with regard to contingent liabilities are the following.

1. To ensure that all such likely libilities have been accounted for and shown in the Balance Sheet. The amount of such liabilities can be estimated by referring to the books of account, correspondence, minute book etc.
2. Consult the solicitor of the client to assess the value and genuineness of such liabilities.
3. To ensure that the provisions of Schedule VI, Part-I of the Compananies Act, 1956 which prescribes the form of company's Balance Sheet are complied with regard to contingent liabilities.

10.4 ADVANTAGES OF VERIFICATION OF LIABILITIES

Careful verification of liabilities will fetch the following advantages.

1. A true and fair position of the business shown by the Balance Sheet.

2. Proper recording and verification of liabilities.

3. Guard against misappropriation of loans.

4. Avoidence of unnecessary loans.

10.5 DIFFERENCE BETWEEN VERIFICATION AND VOUCHING

Verification and Vouching differ in the following way.

VOUCHING	VERFICATION
1. Arithmetical Accurancy : In vouching the auditor only examines the arithmetical accuracy and bonafide of the transactions in the books of account	In verification he has to ensure that the assets as recorded in the balance sheet really exist
2. Checking : In vouching only the entries are checked.	In verification once the auditor is sure of the existence of assets he has to check up whether the assets are free of charge or not.
3. Existence : In vouching the auditor comes to know what should be in existence.	In verification the auditor comes to know the actual existence, freedom from encumbrances and proper valuation of assets.
4. Inquiry : In vouching the auditor check receipts and vouchers.	In verification the auditor should also inquire of the executives about the ownership or leased property.
5. Legal Documents : In vouching auditor may not go through the vouchers.	In verification, the auditor can look at and go through the legal and official documents as also interrogate the responsible officials of the client.

10.6 SUMMARY

Verification of liabilities is as much important that of assets. Liabilities are not the statements of opinion but statements of fact in most of the cases. The contingent liability is, however, exception to this as it is only an estimate, but it is not included with other liabilities. The question of valuation of liabilities does not arise as exact amount of responsibilities can be determined. Capital is the important item on the liabilities side of the Balance Sheet. It should be verified exhaustively, particularly in the first audit.

While a verfication of Debentures he should keep in mind the provisions of section 293(1) (d) of the companies Act 1956 putting limitations on borrowing. In case of redeemable debentures have been issued, the auditor should ascertain the terms of redemption. In case of trade creditors he should obtain statements of account from the various creditors directly and then verify them carefully. While verification of bills payable he should call for letters of confirmation from the drawers of the bills and check the amount of unpaid bills. Thus loans, outstanding expenses contingent liabilities are verfied carefully.

10.7 SELF-ASSESSMENT QEUSTIONS

Five Marks Questions

1. What are advantages of verification of liabilities.

2. How to verify the Capital on Liabilities side of Balance Sheet.

Ten Marks Questions

1. What are the differences between Vouching and Verification.

2. Explain Verification of any four Liabilities.

10.8 GLOSSARY

Contingent Liability

It is used in the accounting sense to designate a possible liability of presently determinable or indeterminable amount which arise from past circumstances.

Outstanding Expenses

The expenses which are due but not paid.

Debenture

A debenture is a written acknowledgement under the seal of the company for a debt due by the company undertaking to pay the debt and interest.

Secured Loans

Loans having a charge or mortgage.

10.9 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr. Kanaka Durga

LESSON -11
CONCEPT OF INVESTIGATION

OBJECTIVES

The objectives of the lesson are:

- To know the Concept of Investigation;
- To Understand the Differences between Auditing and Investigation; and
- To Describe the Objectives of Investigation.

STRUCTURE

11.1 INTRODUCTION

Investigation systematic and critical examination and an in-depth inquiry into the accounts and recorded of an organization for a special focus. It differs from an audit in as much as it is not primarily carried out for the focus of ascertaining whether a balance sheet is properly drawn up but rather for the focus of obtaining information of a particular nature required by a client or, in the case of an investigation of fraud, for the purpose of ascertaining its extent

11.2 MEANING AND DEFINITION OF INVESTIGATION

As already mention that it is a special type of investigation of accounts and records conducted by an investigator with aim of specific objective. It is done with a view establish a fact or evaluate a state of affairs or to determine causes of happening in business. In simple words, an investigation is nothing but a thorough examination of books of accounts and records of an organization to determine the financial position and go detect errors and frauds still, to understand this term more detail and accurate some of the quotable definitions are enlisted below:

According to Taylor and Perry, “Investigation involves inquiry into facts behind the books and accounts, into the technical, financial and economic position of the business or organization”.

According to Dicksee, “An investigation is an examination of accounting records undertaken for a special purpose: in effect it is an audit of which the scope is limited or extended in accordance with requirement of the particular purpose. Its object is usually to discover and display the fact in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly”.

According to R. A. Irish, “While auditing procedure may be adopted for a great deal of work, in investigation an investigator must approach his work in critical and perhaps with suspicious state of mind. He may be deeply concerned about what should have been done rather confirmation of what has been done”. Further, “An investigator may be intensely in question of policy, a problem which is legally outside the scope of an auditor’s liability”.

According to Spicer and Paglar, “The term investigation implies an examination of the accounts of a business for some special purpose”.

Thus, with the above definitions one can conclude that an investigation is a special type of examination of accounts and records carried only the investigator with a pre-determine purpose in accordance with the necessity of the situation and or concerned with something more than the verification of accuracy of the figures of the financial statements.

11.3 ESSENTIAL FOR INVESTIGATION

An investigator should keep the following points in view during the course of the investigation:

1. He should keep himself free from the influence of Directors and Managers of the business.
2. He should familiar himself with all the important details about a business before the commencement of his work.
3. If necessary, he should seek the assistance of technical experts during the course of his enquiry.
4. He should confine to himself the purpose of investigation and keep details in regard thereto quite secret.

11.4 NATURE OF INVESTIGATION

Investigation is a vital part of auditing process but only applied when the event or transaction is beclouded. It is carried out when lapse have been established to ascertain who is responsible, the reason for the action including the extent of damage if any. It could be referred to as a detailed verification and clarification of doubt about a transaction or event. The search and examination of the particulars of an event to determine the hidden, unique, or complex facts surrounding the event. A deliberate search and review of records in accordance with the laid down and agreed policies in order to ascertain if and why the keeping of the records resulted in a gap and the responsible person. Investigation is a structured gathering of documentary evidence and testimony to resolve an allegation of improper activity.

11.5 SCOPE OF INVESTIGATION

The scope of the investigation is quite different from that of the audit. Much depends upon the terms of the investigation. Thus, its scope may be more extensive or limited depending on the circumstances of the case. The enquiry under investigation may go beyond the books of accounts of a business concern. It may cover matters of technical and financial nature. An auditor through investigation tries to establish a relationship between the causes and the findings. Thus, investigation means an enquiry into the details so that actual facts can be analysed with causes.

When an investigator is appointed by his client, he should obtain in writing all the necessary instructions from him so as to decide for himself the scope of work to be performed in pursuance of a special object. If any limitations are placed on his work, he should obtain them in writing so that he may exactly determine the scope and nature of his duties.

The following are some of the investigations commonly met with in practice.

- Investigation on behalf of an individual or firm proposing to buy a business or for investment purpose.
- Investigation on behalf of a bank for credit purpose.
- Investigation on behalf of a prospective shareholder.
- Investigation for claims under an insurance policy covering consequential losses.
- Investigation for the purpose of business re-organisation and reconstruction or for merger and acquisition.
- Investigation in case of suspected fraud-misappropriation, defalcations, theft of cash and other property of a concern
- Investigation on behalf of a business where fraud is suspected or known to have taken place etc.

11.6 DIFFERENCES BETWEEN AUDITING AND INVESTIGATION

The relationship of Auditing and Investigation is very close but they are different. The main points of distinction between auditing and investigation may be explained:

Basis of Distinction	Auditing	Investigation
1. Purpose	It is conducted to ascertain whether the Balance sheet exhibits the true and fair view of the concern	It is conducted with some special purpose eg, to know the earning of the business, to know the actual financial position of the Company etc.
2. Carried out	Audit is conduct on behalf of the proprietor	Investigation is carried out behalf of proprietor or on behalf of third parties also
3. Nature	It is extensive in nature	It is intensive in nature
4. Scope	It implies the examination of the accounts of the business	It involve not only the critical examination of the accounts but also an exhaustive and close enquiry into other matters relevant to the purpose of investigation
5. Qualification	Auditing should be conducted only by a practicing C.A	Investigation may be conducted by any person the need not be a C.A
6. Conducted by	The person who conducts the audit is called the auditor	The person who conducts investigation is called the

		investigator
7. Compulsion	Audit is compulsory in case of joint stock companies	Investigation is not legally compulsory
8. Time Period	It is a kind of test checking	It is a thorough examination of the accounts of business for certain years
9. Approach to work	It is a kind of test checking	It is a thorough examination of the accounts of business for certain years
10. Adjustment of Accounts	No adjustments are done in the case of audit since annual accounts are already prepared	Certain adjustments have to be made to ascertain the net or actual earning capacity of the business
11. Evidence	In case of auditing, the auditor is concern only with prima-facie evidence	In case of investigation, the investigator is concerned with sustentative evidence and sometimes conclusive evidence are also seen
12. Investigation of Audited Accounts	Books and accounts are checked for the first time in case of audit	In most cases of investigation of books presented are already checked and auditor

These were the differences between auditing and investigation

11.7 TYPE OF INVESTIGATION

We have already seen that investigation is a comprehensive discipline. Following is the classification of investigation:

11.7.1 Investigation of sole proprietary concern

Sole proprietors are not required by any law to have their accounts investigated. Despite this fact, many of them who derive their large incomes from different sources i.e., from property and shares etc. and whose expenditure is vast and varied, get their accounts investigated. In such cases, the investigation or also acts as an accountant and prepares the final accounts besides investigating the accounts. As he is appointed by an individual, he must get clear instructions from his client in writing regarding the nature of work he is expected to do. Is scope of work, nature of duties and responsibilities will depend upon the agreement that he has entered into with the client.

11.7.2 Investigation of partnership firm

Nowadays, a majority of agreements of partnership provide for the accounts of the partnership firm to be investigated by an independent investigator. However, the Partnership Act of 1932 does not require it. In case, the partners decided to get the accounts of the partnership firm investigated, then an investigator is appointed by an agreement and his rights and duties are determined by a mutual agreement between the investigator and his client.

11.7.3 Investigation of companies

A unique feature of company form of organization is that the ownership and management lie in the hands of different people. Therefore it is mandatory for companies to get their books of accounts investigated. The financial statements are prepared by the management.

11.7.4 Investigation of Government department

Public utilities and government departments like Electricity Boards are also subject to investigation. These departments also have system of internal investigation. The constitution of India makes the requirements for such investigation.

11.7.5 Continues investigation

A continues investigation is one which the external investigator's staff is occupied in a detailed examination of the books of accounts of the client the whole year round or at regular intervals, say weekly, monthly and quarterly. It is a system investigation in which the investigation work is carried on almost simultaneously with the recording of transactions.

11.7.6 Final investigation

Periodical or final or annual investigation: A system where the investigator takes up his work of checking the books of accounts and other related documents, only at the end of the accounting period when the transactions for the whole financial year are completely recorded, balanced, the trial balance is then drawn out and the final accounts have been prepared is known as periodical or final or annual investigation. The investigationor will normally start routine checking of the books and other investigation procedures only after the close of the financial year. He would complete his investigation work in one continues session or without any interval. In other words, the investigator visits his client only once a year and goes on checking the accounts and other related documents until the investigation work for the whole period is completed.

Some of the common types of investigation in auditing are:

- Acquisition of companies
- Purchase of business
- Prospective investments
- Admission of new partner
- Fraud
- Systems break down
- Prospective lending
- Company acts investigation

11.8 OBJECTIVES OF INVESTIGATION

The need of investigation may arise in many cases, but these are some of the circumstances where investigation is most frequently called for:

11.8.1 For purchasing any business

Investigation can be conducted by a person on behalf of his client, when the client intends to purchase an existing business.

11.8.2 For admission of a new partner

Investigation into the affairs of a partnership firm can be made by any person on behalf of the incoming partner of an existing partnership business.

11.8.3 For seeking avenues of investment

In order to measure the financial solvency position of any business, investigation can be done. The financial solvency is measured through investigation on behalf of a person who seeks avenues of investment.

11.8.4 For granting loan or financial assistance

Investigation can also be undertaken on behalf of a bank or other financial institutions proposing to extend or grant loans to its client or alter the terms and conditions of the same.

11.8.5 For suspected fraud

If the owner or the management suspects fraud, they can appoint an investigator to detect the fraud activated by the employees.

11.8.6 For abnormal fluctuation of profit

Investigation can be conducted on behalf of the owner or the management of a business in order to ascertain the reason of abnormal fluctuation in profit in the organisation.

11.8.7 For settlement of tax liability

Investigation can be undertaken for the settlement of tax liability or in some cases for the detection of undisclosed income of the assessee.

11.8.8 For settlement of insurance claim

In case of fire or other hazards, the organisations have to submit claim to the insurance company to recover the loss. The insurance company can appoint an investigator to determine the exact amount of loss for settlement of claim.

11.8.9 For valuation of goodwill and shares

The shares and goodwill of the business are required to be valued on different occasions. In order to calculate the fair value of shares and goodwill, investigation can be undertaken.

11.8.11 For judging sickness of a business unit

Government may consider to take over a sick industrial unit and for this purpose, it may give appointment to an investigator to investigate into the affairs of the sick unit.

11.8.11 For the provisions of the Companies Act

Sections 235 to Section 251 of the Companies Act provide regulations for the investigation of any company under different specific situations.

11.8.12 For justifying negligence of the auditor

In some cases, the auditor is held liable for negligence in his duty. But before accusing auditors for negligence, the case has to be properly investigated.

11.8.13 For complaint by the shareholders

Investigation can also be undertaken by the management on the basis of complaints made by the shareholders.

11.8.14 For the affairs of a trust

Investigations are sometimes required to be conducted on behalf of the beneficiaries of any trust into the affairs of a trust for suspected fraud.

11.8.15 For **the liquidation of the business**

Investigation of suspected fraud or misfeasance against the Directors on behalf of the liquidator of a company could also be undertaken.

11.9 IMPORTANCE OF INVESTIGATION

In addition to regular investigation of the books of accounts of an enterprise, there may be the requirement of thorough examination of the accounts and records of past several years to fulfill certain objectives from time to time. In order to carry out thorough examination of books of accounts and records of an enterprise, investigation is undertaken. Investigation implies an enquiry into the accounts and business records to attain certain specific objective. In most cases, the purpose of such enquiry is to ascertain the true financial position of the concern or its normal profit-earning capacity or the extent of fraud. Thus, investigation is a special type of examination of accounts and records carried on by an investigator with a pre-determined objective according to the requirement of the situation and entail something beyond the verification of accuracy of figures in the financial statements.

Auditing is conducted to verify the extent of truthfulness and fairness of the financial records of an entity, but Investigation is performed to prove a certain fact. The scope of the auditing is based on the Standards on Auditing, but the scope of the investigation rests on the terms of engagement.

The purpose of an investigation is to establish relevant facts to prove or disprove allegations of fraud and corruption. It is a legally established fact-finding process conducted in an impartial and objective manner, with the aim to establish the relevant facts and make recommendations in this connection. However, investigation is conducted in deduction of suspected fraud and theft, to identify causes for continuous loss and low productivity and to evaluate the credit worthiness of business. The purpose of an investigation of a potential violation

Violation of the Anti deficiency Act is to determine what happened, what the causes were, who was responsible, what actions should be taken to correct the current situation, and what actions should be taken to ensure that a similar violation does not occur in the future.

11.10 QUALITIES OF AN INVESTIGATOR

The investigator should have the following qualities/abilities

1) He need not be a chartered accountant but he must have sound knowledge of accounting and auditing.
2) He should have practical knowledge about the various affairs and activities of an organisation
3) He must have ability and competence to understand different critical matters clearly.
4) He must have good ability to grasp things easily express them in clear words.
5) He should approach the wok methodically.
6) He must have the quality of the working honestly and diligently.
7) The investigator should possess the ability of working for the interest of his client and he must work with the feeling of some service to the client.
8) While performing the duty of investigation, he must exert almost care, skill and responsible diligence keeping in mind all through the purpose of investigation.
9) The subject of the investigation is highly technical in nature and usually a senior accountant with profound knowledge and experience suitable for the job.

11.11 DUTIES OF AN INVESTIGATOR

The procedures to be followed in an investigation depend on the nature of investigation, its purpose and the circumstances of the case in which the investigation was undertaken. In all the cases of investigation, certain precautionary measures are required to be taken by the investigator. These measures are considered as the duties of the investigator, which he should follow in discharging his duties in conducting investigation. These duties are given below.

11.11.1 Obtaining written instruction about scope and objectives of investigation

Before starting an investigation, the investigator should obtain from the client clear written instruction about the scope of his work and purposes of investigation. If the client is interested to impose any restriction or limitation to his work, he should also get it in writing so that he may exactly determine the scope of his work and the nature of his duties.

The period to be covered in the investigation should also be confirmed by the investigator from his client clearly in writing. The period is very important because the investigator can accordingly restrict his examination of transactions and records to that period only.

11.11.2 Framing investigation programme

Based on the objectives, scope and period to be covered, an effective investigation programme should be chalked out. The investigation programme should be flexible, so that the investigator may make required changes in the programme during actual investigation. Such flexibility in the programme is necessary, since many steps in an investigation depend on the results of the earlier steps.

11.11.3 Collection of information about the business

It is not possible for the investigator to give correct interpretation and reporting of the fact, if he does not have the detailed knowledge of the activities of the enterprise for which he is to conduct investigation. So, before starting his work of investigation, the investigator should collect all relevant information about the activities of the enterprise.

11.11.4 Enquiry about the reputation of the enterprise

The investigator should make enquiries and collect information about the reputation of different individuals working in the organisation. Information should also be obtained about the goodwill of the enterprise. This information will help the investigator a lot in preparing his report.

11.11.5 Taking expert advice

The investigator should take the assistance of experts during the course of his examination, if required, and consult experts on matters in which his knowledge is not adequate.

11.11.6 Reliance on accounts and records

If the books of accounts and required records have been properly maintained and the accounts have been audited, the work of the investigator becomes simplified as he is entitled to rely upon the audited accounts and properly maintained records.

So, usually the investigator should avoid duplication of work and concentrate more on such procedures as will be more purposeful for investigation. But the fact that the investigator has depended on the audited books of accounts should be included in the investigation report.

11.11.7 Preservation of working papers

It is the duty of the investigator to maintain his working papers properly. A complete record of work carried out, records examined, relevant information and evidence collected etc. should be kept in his file together with important statements, schedules and documents. These working papers will help him at the time of finalization of report. These working papers can also be valuable documents in his defense, in case the affected parties subsequently challenge his findings.

11.11.8 Maintenance of secrecy and confinement to purpose

The investigator should always keep in mind the purpose of investigation, as the purpose of investigation will determine which records and figures should be examined in detail, which need not be examined, for which cases detailed checking may be avoided, what information he should seek from sources other than books and records and what procedures should he adopt in his investigation work. On the other hand, secrecy is the basic necessity of any investigation. So, the investigator should keep the details of the investigation very secret.

11.11.9 Maintenance of minimum standard of work

The investigator must be honest and he should approach his work with reasonable care, skill and diligence. He should not allow himself to be influenced by others, as total independence is required in investigation. So, the investigator should always keep himself free from the influence of interested persons.

11.11.11 Proper and correct reporting

The investigation report should be clear and unambiguous. The investigator should analyse the data and evidence collected by him. He must take great care to see that his report does not contain any wrong information. So, before signing his report, he should carefully check the content of his report with preserved working papers and notes. This is very important as incorrect report may mislead his client and invite legal action against him.

11.12 INVESTIGATION REPORT

The report on the investigation must be carefully prepared. It should be simply worded, very clear in its meaning and as concise as practicable in the given circumstance. It must, however, give full consideration to all the factors affecting the decision to be made.

The form of the report will normally be an introduction setting out the terms of reference and the nature of the enterprise being investigated. A main section will be there setting out the facts ascertained and detailing the work performed, and a final section setting out the conclusions and the recommendations. It should be remembered that the main points of the report are not obscured by details; any voluminous statistics should be relegated to appendices and referenced to the relevant part of the report.

11.13 SUMMARY

For a business organisation, investigation implies that an organised, detailed and critical examination of the books of accounts and transaction records (both past and present) of an entity, conducted for a specific purpose or to reveal a truth or to establish a fact with the help of evidence. The most common methods employed in the process of investigation are searching, observation, interrogation, inquiry, inspection, etc.

We can now conclude that **Auditing** is counted to verify the extent of truthfulness and fairness of the financial records of an entity, but **Investigation** is performed to prove a certain fact. The scope of the auditing is based on the Standards on Auditing, but the scope of the investigation rests on the terms of engagement. It is quite normal that people get confused between these two terms easily due to lack of knowledge and proper understanding. Investigation in Auditing includes the assessment of records and the utilization of bookkeeping techniques to find money-related inconsistencies and to follow the movement of assets and funds all through associations.

A unique feature of company form of organization is that the ownership and management lie in the hands of different people. Therefore it is mandatory for companies to get their books of accounts investigated. The financial statements are prepared by the management.

The purpose of an investigation is to establish relevant facts to prove or disprove allegations of fraud and corruption. It is a legally established fact-finding process conducted in an impartial and objective manner, with the aim to establish the relevant facts and make recommendations in this connection. However, investigation is conducted in deduction of suspected fraud and theft, to identify causes for continuous loss and low productivity and to evaluate the credit worthiness of business. The purpose of an investigation of a potential violation

Violation of the Anti deficiency Act is to determine what happened, what the causes were, who was responsible, what actions should be taken to correct the current situation, and what actions should be taken to ensure that a similar violation does not occur in the future.

11.14 TECHNICAL TERMS

Investigation: According to the Oxford English Dictionary (OED), “investigation” is derived from the Old French word of the same name originally coined around the 14th Century. It is also similar to a Latin word “investigate” which means to investigate. In general, an effort made to find out the facts, behind a particular situation, to discover the truth is known as Investigation.

Misconduct: Generally speaking, “misconduct” refers to any inappropriate action, offence, or professional fault committed willingly or deliberately by a person while working for an employer. Misconduct occurs when an employee’s behaviour is in violation of the obligations set out in their contract of employment and when, under normal circumstances, the employee should have known that the actions, omissions or faults could result in a dismissal.

Inquiry: A systematic investigation of a matter of public interest.

Evidence: “something (including testimony, documents, and tangible objects) that tends to prove or disprove the existences of an alleged fact. Internal Audit: The process of providing independent assurance that an organization’s risk management, governance, and internal control processes are operating effectively.

Audit Report: An independent auditor’s primary responsibility is to report on whether the basic financial statements, including the notes, are presented fairly in accordance with the governmental entity’s applicable financial reporting framework. The type of report the independent auditor issues depends primarily on the contents of the basic financial statements and the scope and results of the audit.

Working papers: Documents that summarize and record all the activities and evidence obtained during an audit or investigation.

Analytical Procedures: Analytical procedures are a form of audit evidence. Procedures include analyzing plausible relationships among both financial and nonfinancial data. Additionally, these procedures help identify fluctuations or unusual transactions that are different from the auditor’s expectation.

11.15 SELF ASSESSMENT QUESTIONS

1. Define and explain the term ‘investigation’.
2. What is investigation? Discuss the nature and scope of investigation?
3. Explain the distinction between investigation and auditing
4. Discuss the objectives of investigation.
5. What is investigation? Briefly explain the different types of investigation.
6. Write short notes on:
   a) Duties of an investigator.
   b) Qualities of an investigator.
   c) Investigation Report.

11.16 REFERENCE BOOKS

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LESSON – 12

FEATURES AND CAUSES OF INVESTIGATION

OBJECTIVES

After studying this lesson student should be able to:

- Understand the features of investigation.
- Study the causes and objects of investigation

STRUCTURE

12.1 INTRODUCTION

Apart from the regular and an efficient audit, an investigation should be conducted in an organisation with some specific objectives from time to time. Though, it is not compulsory but it should be conducted regularly for ascertaining the financial position of the business, normal capacity of earning profit and to extract frauds. Actually it is nothing but a detail examination of record and accounts of the business. Thus, an investigation plays an important role in auditing. Hence, in this lesson much efforts have been made to explain this term in detail, i.e. its meaning objectives, duties of investigator, investigation report and so on……

12.2 FEATURES OF INVESTIGATION

"An investigation is an examination of accounting records undertaken for a special purpose; in effect it is an audit of which the scope is limited or extended in accordance with the requirement of the particular purpose. Its objective is usually to discover and display the facts in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly."

On analysis of the above definition given by various eminent scholars, one can draw the following inherent features of investigation:

1) It is a critical and thorough examination of books of accounts and records of an organisation.
2) It is undertaken with certain suspicion, depending on the cases.
3) Apart from detail analysis and study of books and records, personal examination of directors, auditors and other officers are also undertaken in the investigation.
4) Investigation is not confined to the financial aspects of the business but also other aspects like technical, political, economical and managerial are also considered.

5) Investigation is conducted with specific objectives.
6) The scope of investigation may be limited or extended as the case may be.
7) The investigator has to submit his report only to that person who is responsible for his appointment.
8) The investigator should mention factual information in his report in a very analytical and descriptive manner.
9) The investigation is not conducted with specific rules and regulations but it is a voluntary and contractual in nature, i.e. no statutory provisions prescribed for it.
10) This investigation suggests the outline for the future course of action or a particular problem.

12.3 DIFFERENT CLASSES OF INVESTIGATION OR OBJECTS OF INVESTIGATION

Following are the usual circumstances which most frequently call for various types of investigations:

1. Investigation on behalf of a person who intends to join an established partnership.
2. Investigation to find out the earning capacity of the running concern proposed to be taken over on behalf of an individual, partnership firm or joint stock company.
3. Investigation in case of a suspected fraud – misappropriations defalcations, theft of cash and other property of a concern.
4. Investigations on behalf a person who wants to lend money to a concern. He would like to know the financial position of such a concern.
5. Investigation on behalf of a prospective shareholder.
6. Investigation for claims under an insurance policy covering consequential losses.
7. Investigations under the Indian Companies Act 2013 – There are provisions in law where the shareholders, creditors, registrar of Joint Stock Companies and the Competent Court may apply to Central Government to get the affairs of the companies investigated. (Sections 235 to 251).

All these cases are discussed separately.

12.3.1 Investigation on behalf of a person who intends to join an established, 'partnership Business as a Partner' or on behalf of an Incoming Partner

The object in view for such investigation is to find out whether it will be advisable or not for the client to join the firm. In order to arrive at such decision, the following points must be examined by the professional accountant.

- He should ascertain the bonafide reasons as to why partners of the firms are allowing a new person to join their business. He should also study the partnership deed to ascertain that there is no restriction on the admission of a new partner.
- He should find out whether the capital to be contributed by his client is to be utilized in paying off the old liabilities of the firm or settling claims of a retiring partner or a deceased partner or it would be utilized for the expansion of business.
- He should find out whether the amount of goodwill to be paid by this client is a reasonable one. He should examine the past earnings and future prospects of the business and then he should recommend the amount of goodwill which hius client should pay. He should also ascertain as to how the goodwill shall be written off from the books of accounts.

- He should give special attention to the earning capacity of the business. He should make a comparative study of the Trading and Profit and Loss Accounts for the periods covered by the investigation in order to ascertain the true earnings of the business. He should also examine purchases, sales, stocks and expenses of the business and the percentage of profits on turnover.
- He should examine the balance sheet of the firm and ensure that the values placed upon the existing assets and liabilities are as per the rules of valuation. Assets are not shown at inflated values and no liabilities are omitted. If the assets are over –valued and there are omissions of the various liabilities of the firm, it may result into over valuation of the capital of the existing partners which will adversely effect the interest of the incoming partners especially in the event of dissolution of the firm.
  He will also examine the adequacy of various provisions for the losses or bad debts in the value of assets besides scrutinizing the stock-sheets and examine the valuation of stocks carefully.
- He should ascertain the probable amount of profit which the incoming partner may expect to receive from the business. It will help him to know whether his client will be able to get a fair return on his capital contribution or not.
- He should see whether any specialised or technical knowledge is necessary for the successful conduct of the business. If the existing partners that knowledge and his client does not, the extent to which he will find himself handicapped needs to be known.
- He should study the terms of the proposed partnership agreement, and the 'partnership deed' of the existing partners to know their capital contribution, drawing rights, job allocation, financial management system etc. in order to ascertain the fairness and reasonableness of the proposed agreement from the point of view of his client's interest. He should see that the firm has cleared its income tax liabilities if not then find out the provisions made to clear such taxes.
- He should note the insurance cover to find out whether all relevant areas are adequately covered under the insurance.
- If the new partner is required to step into the place of a retired or deceased partner, the investigator should enquire into the effects and consequences of such a death or retirement of a partner on the business of the firm and the prospects of improvement in business on the admission of a new partner.
- Investigator should also make enquiries about the financial standing of the existing partners.

12.3.2 Investigation on Behalf of a Purchaser to Ascertain the Earning Capacity of a Running Business Concern

When someone intends to purchase an existing business as a going concern, he would be interested to know the reason for the sale of the business, the earning capacity, the correct values of the assets and liabilities to be taken over, responsibilities of the purchased concern, estimation of the value of good-will and the probable future prospects of the business. In short, he would like to know as much as possible about the business so as to enable him to form an opinion about the net worth and how much he should pay for it. A professional accountant, who is called upon to undertake an investigation of this type, should realize his responsibility in the matter because to a very large extent, the client's decision in this regard will be primarily guided in his report. Therefore, he should pay attention to the following points.

(i) He should make a thorough enquiry into the reasons which cause the present proprietor to sell the business.
(ii) He should find out whether the business requires particular skill or influence. In case the concern enquires special type of skill which the purchaser may not possess, it would not be in his interest to invest money in such a concern.
(iii) He should make sure that the assets and liabilities have been properly valued.
(iv) He should see that the assets and liabilities are shown in the balance sheet at their correct values and proper provision for bad and doubtful debts and depreciation has been made.
(v)The goodwill of the concern should be properly valued and the auditor should study the basis of valuation.
(vi) He should also see the present conditions of the various plants, and machineries. It will help him in finding out the future life of these important assets.
(vii) He should examine the previous year's audit report, if any.
(viii) Actual profits of a business may be quite different from its net profits as disclosed by the profit and loss account. He should therefore, ascertain the true earning capacity of the business. In order to form a correct estimate of the profit earning capacity of the concern, he should do the following things"

- He should make a careful examination of its profit and loss account for the period covered by the investigation.
- He should re-draft the profit and loss account in a tabular form. This will facilitate comparison of figures for several preceding years. If there has been any change in the accounting policies during these years, the figures may be re-adjusted so as to set them out on a uniform pattern.
- He should make a careful examination of the accounts of the previous years in order to see that there has been no attempt at window dressing.
- He should undertake detailed examinations and vouching of the books of accounts, particularly of capital and revenue expenditure as well as the deferred revenue expenditure.

(ix) He should find out the amount of working capital and ensure that it is sufficient to carry on the business.
(x)He should also see the terms of contract with the existing employees.
(xi) He should examine the condition of stock-in-trade.
(xii) He should make full enquiries regarding the verification and valuation of stock-in-trade. This item is subject to greater manipulation. Sometimes, the profits of a concern may be inflated by the following methods:

- Inflation of closing stock.
- Inclusion of fictitious assets.
- Omission of purchases.
- Inclusion of goods sent on consignment or goods sold on sale and return basis as complete sale.
- Omission of wages and other manufacturing expenses.
- Making less provision for depreciation or less provision for bad and doubtful debts.

The necessary adjustments should be made in order to arrive at the correct figures.
(xiii) The amounts of debtors and creditors to be taken over should be thoroughly checked.

(xiv) He should examine the Memorandum of Association, Articles of Association and the Prospects of the Company.

(xv) He should find out the amount of authorized, issued, called up and paid up capital of the company. He should also note down the amount of uncalled capital and the calls in arrear.

(xvi) He should examine the rights attached to the different classes of shareholders of the company.

(xvii) He should also enquire about the rate of dividend which has been paid up by the company to its shareholders in the last three to five years.

(xviii) He should find out the present value of the share from the stock exchange.

(xix) He should also make a correct valuation of all the assets and liabilities of the company.

(xx) He should also inspect the 'Register of Mortgages and Charges' to ascertain mortgages and charges etc. on the assets of the company.

The Investigator should make the following deductions and additions to the figures of net profits as shown by the profit and loss account of the business.

12.3.3 Investigation in case of a suspected fraud – misappropriations, defalcations, theft of cash and other property of a concern

Sometimes investigations can be conducted to detect the fraud. This fraud is generally done by those persons who handle cash and cash. The investigator should know the nature of fraud suspected and the names of suspected persons. Generally, the fraud is possible when the internal check system is weak and therefore, the investigator should examine the internal check and accounting system thoroughly.

The fraud is generally, committed in the following ways:

By misappropriating cash by the employees

1) By misappropriating goods by the employee
2) By manipulating of the accounts by the proprietor himself or by the concerned officers:

12.3.3.1 Misappropriating cash

Cash is, generally, misappropriated in following ways:

(i) Omitting to record the receipt of cash either fully or partially.
(ii) Making and entering fictitious payments.
(iii)Entering more amount than what has been actually received

12.3.3.2 Misappropriation Goods

It is very difficult to detect the misappropriation of goods as generally. It is done by the old and trusted employees of the business, and becomes more difficult to detect the goods are small in size but costly in value.

(i) He should thoroughly check the issue and receipt the system goods
(ii) He should see that the stock accounts are up-to-date
(iii)He should further check the order received book, sales book, godown keepers book and invoices.

12.3.3.3 Manipulation of Accounts

Accounts are manipulated either by:

(i) The proprietor of the business
(ii) The partner of the partnership firm
(iii) The directors of the company
(iv) The employees of the company

12.3.4 Investigation on behalf of a person who wants to lend money to a concern. He would like to know the financial position of such a concern.

The business organisations get their financial assistance from banks and financial institutions apart from their financial strength. If a customer approaching for financial help in the form of loan to the banks and financial institutions will assess the financial capacity of the customer. The lasted audited balance sheets of the party’s account do not serve the purpose of the bank. In such circumstances an investigator is appointed to investigate into a financial position of the borrower and to advise whether the money should be lent to the party or not.

The investigator should pay attention to the following points while he is conducting investigation:

(i) He should asses into the conditions for which loan is required.
(ii) The investigator should collect the information regarding the existing liabilities of the business, their duration and rate of interest.
(iii) He should also find out whether any other bank or financial institute is rejected to give loan and also should examine the reasons for such rejection.
(iv) The investigator should further examine the nature and the exact value of the security and whether that security has already a prior charge and if so, what is the value of that charge.
(v) The investigator should examine the financial position of the borrower because it is to judge his repayment capacity.
(vi) He should enquire about the concerned officers of the business regarding their character, abilities, experience and honestly.
(vii) If the joint company is applied for loan, he should examine that the proposed loan is within the borrowing power of the directors.
(viii) The investigator should examine the ratio of current liabilities to the liquid assets.
(ix) He should be satisfied with the income tax assessment of the concern for the last two or three years.
(x) He should confirm the ability of the repayment capacity of loan of a concern by preparing schedules of all the assets of the firm.

12.3.5 Investigation on Behalf of a Prospective Shareholder

The shares of a private limited company cannot be sold or purchased in the open market. But, the articles of association of a private company may empower that the shares may be transferred, only to the existing shareholders of the company at a fair value. The fair value can be determined by the auditors of the company. But still the prospective purchaser would like to see the advice of n investigator to know their fair value before purchasing such shares. The investigator, while determining the fair value of shares, must consider the following points:

(i) Safety of the capital.
(ii) Earning capacity of the business.
(iii) Any old sale and purchase price of the shares, and
(iv) Current level of dividend.

After collecting the above information, he starts out the work of finding out the 'fair value' of the shares. He can determine it by applying two methods:

- On the basis of average past profits, and
- On the net assets of the company. Here, net assets mean the book value of assets minus liabilities (all types of outside creditors).

It shall also be useful if the investigator find out the general business trend, capital and money market position, resources and abilities of management dividend policy and adequacy of reserves etc.

12.3.6 Investigation for claims Under the Insurance Policy Covering Consequential Loss

It is very common among the business community to get their factories and business houses insured against fire. In case the factory or office catches fire, the owner not only suffers the loss due to destruction of goods and other assets but also he suffers an important loss, i.e., the profits that he would have earned, had there been no fire. From the date of the incident till the insurance claim is settled, he suffers a great financial loss. In order to minimize such losses, a businessman usually takes a policy which also covers consequential loss. The 'loss of profit' is calculated and assessed by a surveyor (investigator) in accordance with the terms of the contract of insurance. The investigator should be very careful in his assessment because his report will be of great value in deciding the claims. The insurance company cannot dispute the findings of the investigator unless he had failed to take into consideration some material fact He should take into account the following three points in order to make a correct assessment of the loss:

(i) Turnover of the last year.
(ii) The increased cost of working.
(iii) The period for which this loss is to be calculated.

It would be remembered that one cannot claim more than the sum is insured. In case the loss is more than the sum insured, the insurer will bear a certain percentage of this loss.

12.3.7 Investigations Under the Companies Act, 2013

Sections 210,211,212,213 and 2016 of the Companies Act, 2013, provide for the investigation into the affairs of a company. Two types of investigations as mentioned below are contemplated:

(i) Investigations into the affairs of a company by the inspector falls under section210 and 213 including investigations into the affairs of the related companies under section 212. The term 'affairs of a company' implies or refers to an investigation into all the business affairs of the company, i.e., profit and loss, investments, shareholdings in subsidiary companies, contracts or any other matter, and
(ii) Investigations of the ownership of a company.
(iii) Investigations into the affairs of a company: This may further be divided into three parts.

1. Investigations into the affairs of a company by inspector through an order of the Central Government is envisaged under Section 210.
2. Investigations into the affairs of a company by Serious fraud Investigation office as prescribed under Section 212.
3. Investigations into the affairs of a company in other cases as provided under Section 213.

1. The Central Government has to appoint an Inspector or Investigator to investigate into the affairs of a company in the following cases (Section 210)

(i) When the company by a special resolution demands into the affairs of the company on the receipt of report of Registrar or Inspector.

(ii) When the court, by order, declare that the affairs ought to be investigated by an inspector appointed by the Central Government or tribunal requiring investigation in public interest.

It may order an investigation into the affairs of the company.

Further, where an order is passed by a court: or the tribunal requiring investigation, the Central Government shall order an investigation into the affairs of the company.

For the above purposes, the Central Government may appoint one or more persons as inspectors and to investigate into the affairs of the company to report thereon such manner as the Central Government may direct in the affairs of the company.

i. **Who can be appointed as an Inspector:** A firm of professional accountant or a body corporate cannot be appointed as an inspector. However, an individual accountant can be so appointed.

1. As per Section 213 of the Companies Act, 2013 (Yet to come into force) may order investigation into the affairs of the company on an application received by a specified number of members and supported by such evidence or
2. That the business of the company is being conducted with intent to defraud its creditors, members or any other persons dealing with the company; or
3. That the business of the company is conducted for a fraudulent or unlawful purpose or in a manner oppressive to any of its members or that the company was formed for any fraudulent or unlawful purpose; or
4. That the persons concerned in the formation of the company or the management of its affairs have been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members: or
5. That the members of the company have not been given all the information with respect to its affairs which they might reasonably expect including information relating to the calculation of the commission payable to the managing or other director or manager of the company.

ii. **On the Report by the Registrar of Joint Stock Companies:**

1) If the Registrar of Companies makes a written report to the Central Government that the company has not furnished certain information or explanations as asked for from the company within the specified time: or
2) The information or explanation supplied to him by the company is unsatisfactory: or
3) The company does not make a full and fair disclosure of the facts: or
4) The business of the company is carried on for a fraudulent or unlawful purpose [Section 212].

iii. **Powers of the Inspector to Investigate the Affairs of Related Bodies Corporate and Others in the Same Group**

An inspector can be appointed under Section 219 of the Companies Act 2013 to investigate the affairs of a company shall have the following papers:

According to Section 219 of the Companies Act 2013, the inspector can be appointed to investigate into the affairs of the following bodies corporate and the persons related to the company under investigation, to the extent it is considered necessary and relevant in the interest of the proper investigation of such company. (Section 210 or 212 or Section 213 of the Act 2013).

❖ **Powers of Inspectors:**

1. According to Section 217 of the Companies Act 2013, it is obligator for all officers, employees and agents of the company or related bodies incorporate under

investigation to preserve and produce to the inspector all books and papers of the company which are in their custody and are also required to give to the inspector all assistance in connection with the investigation.
2. With the previous approval of the Central Government, the Inspector can also anybody contribute to furnish such information or to produce such books and papers before him.
3. The inspector also has the power examine on oath, any present and past officer, agent or employees of the company under investigation. Whereas inspector finds that a person, whom he has no power to examine on oath, ought to be so examined.
4. The inspector being an officer of the Central Government, making an investigation, shall have all the powers as are vested in civil court under the code of civil procedure, while trying suit in respect/specified matters. Penalties have been prescribed for persons who do not appear or produce books, documents and the required information before the inspector.

The officers of the Central Government, Police, Magistrate or statutory authority shall provide necessary assistance to the inspector for the purpose of inspection or seizure of such books and papers of the company under investigations of any related body corporate or of the managing director or manager of the company or the body corporate, if he has reasonable ground to believe that relevant books or papers may be destroyed or falsified.

The statutory officers may also authorize him to enter the place where such books and papers are kept, to search the place and seize them. He can make identification marks on all such documents and books. At the conclusion of the investigation, the inspector must return all the documents and books.

2. Investigation into the affairs of a company by serious fraud Investigation office under section 212

In The Central Government may, by an order, assign the investigation, into the affairs of a company, in the serious fraud investigation office, when it is consider necessary to investigate into the affairs of the company on receipt of the Registrar or inspector or on intimation of a special resolution passed by the company or in public interest or on request from the department of the Central Government or a State Government

In case the Central Government assign any case to the serious fraud Investigation office, no other investigating agency of Central Government or any State Government shall proceeds with investigation in such a case. The report/interim report shall be submitted to the Central Government for further directions and necessary action. The Central Government may also direct to submit an interim report.

Evidence from place outside India: If in the course of an investigation into the affairs of the company the inspector may make an application to the competent court in India stating that evidences may available in a country outside India. In such a situation, the court may issue a letter of request to a court of an authority in such country or to place for seeking such evidence available.

3. Inspector's Report (Section 223 of the Companies Act)

The inspector if directed by the Central Government has to prepare and submit an interim report (Required) or a final report on the conclusion of investigation to the Central Government. The Government is bound to forward a copy of the report to the company at its registered office and also to any related bodies corporate under investigation or managing agent, secretaries or treasures or associates dealt with in the report. Where the inspector was appointed on the application of the members under section, a copy of the final report is to be furnished to them and where he was appointed on the court's order, a copy must be sent to the court. The Government may publish the report and other interested parties may obtain it on payment of the prescribed fee from the Central Government.

Section 224 of the Companies Act, 2013 deal with the follow up of the inspector's report and state if the inspector's report shows that any person has committed any office for which he is criminally liable, the Government may take the necessary steps to prosecute him for the office and apply for the winding up of the company.

Further, the Government may, on the basis of the report may apply to the court for the winding up of the company of make an application for an order for the prevention of oppression and mismanagement under Section 397 and 398.

If it appears from the report that some fraud, misconduct or misappropriation-misapplication property has been committed; the Central Government may institute proceedings for the recovery of damages regarding fraud or other misconduct or for recovery of the misapplied property.

Section 246 states that the inspector's report shall be admissible in any legal proceedings as evidence of the opinion of the inspector in relation to any matter contained in the report.

The expenses of this investigation are to be defrayed by the Government out of money provided by the parliament. But the Government may order recovery of the expenses from persons on whose application the investigation was ordered.

12.4 SUMMARY

It can be seen, we conclude the lesson rely on the information about the different classes and objects of investigation. The object in view for such investigation is to find out whether it will be advisable or not for the client to join the firm. Sometimes investigations can be conducted to detect the fraud. This fraud is generally done by those persons who handle cash and cash. The investigator should know the nature of fraud suspected and the names of suspected persons. Generally the fraud is possible when the internal check system is weak and therefore, the investigator should examine the internal check and accounting system thoroughly.

However, the business organisations get their financial assistance from banks and financial institutions apart from their financial strength. If a customer approaching for financial help in the form of loan to the banks and financial institutions will assess the financial capacity of the customer. The lasted audited balance sheets of the party's account do not serve the purpose of the bank. In such circumstances an investigator is appointed to investigate into a financial position of the borrower and to advise whether the money should be lent to the party or not.

Therefore, it can be concluded that the concepts of auditing and investigation have manifold differences. Although both the concepts involve the examination of facts and checking on fraud, they are different, with one being a form of the other. Both audits and investigations are regulated by the Companies Act in India and are hence equally significant for the affairs and position of companies in India. Despite their differences, both are statutorily regulated and are subject to the laws of the country. Different aspects of each are individually covered in the law and hence highlight their importance in the detection of and tackling growing financial crimes. Because of the growth of companies with a startup culture, there are ever-growing instances and risks of company fraud.

12.5 TECHNICAL TERMS

Audit Evidence: Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Audit Report: An independent auditor's primary responsibility is to report on whether the basic financial statements, including the notes, are presented fairly in accordance with the governmental entity's applicable financial reporting framework. The type of report the independent auditor issues depends primarily on the contents of the basic financial statements and the scope and results of the audit.

Balance Sheet: The balance sheet reports information about the current financial resources of each major governmental fund and for major governmental fund in the aggregate (GASB 34, paragraph 83). The format of the balance sheet shows assets plus deferred outflows of resources equal liabilities plus deferred inflows of resources, and fund balances.

Certified Fraud Examiner (CFE): The Certified Fraud Examiner (CFE) credential denotes proven expertise in fraud prevention, detection and deterrence. CFEs are trained to identify the warning signs and red flags that indicate evidence of fraud and fraud risk. CFEs around the world help protect the global economy by uncovering fraud and implementing processes to prevent fraud from occurring in the first place. CFEs combine knowledge of complex financial transactions with an understanding of methods, law, and how to resolve allegations of fraud.

Comparative Financial Statements: Comparative financial statements are a complete set of financial statements for one or more prior periods included for comparison with the financial statements of the current period. When comparative financial statements are presented, the auditor's report should refer to each period for which the financial statements are presented and on which an audit opinion is expressed.

Compliance Audit: A program-specific audit or an organization wide audit of an entity's compliance with applicable compliance requirements.

Due Professional Care: Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent person in a similar circumstance. Due professional care is exercised by auditors when they conduct their audits in accordance with the applicable auditing standards.

Engagement Letter: The engagement letter documents the agreed-upon terms of the audit between the auditors and those charged with governance. The agreement should include the objective and scope of the audit, the responsibilities of the parties involved, the timing of the audit, and the expected form and content of reports that will be issued by the auditor.

Embezzlement: Embezzlement is the act of dishonestly taking financial assets from another in a manner designed to conceal the activity and avoid detection.

Subrogation: Subrogation refers to circumstances in which an insurance company tries to recover expenses for an insurance claim it paid when another party was responsible for the payment of the insurance claim.

Statement: A **statement** is a formal account of the facts related to a case. A statement is given by a witness, defendant, or other party related to a case in a court of law.

Theft: Theft, in its simplest terms, is stealing. Theft occurs when a person takes or steals, property or items that do not belong to them. Theft is often used as an informal term for crimes against property, such as: Burglary, embezzlement, larceny, looting, robbery, shoplifting, fraud, and criminal conversion. In some jurisdictions, theft is considered to be synonymous with larceny; in others, the crime of theft has replaced that of larceny. Someone who carries out an act or makes a career of theft is known as a thief.

Fraud: Fraud is an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.

Independent Auditor's Report: The independent auditor's report is a formal letter to communicate the results of the audit. The report will also include the auditor's opinion on the financial statements and whether they are presented fairly in accordance with generally accepted auditing standards (GAAP) or the other comprehensive basis of accounting that is applicable.

Proprietary Fund: Proprietary fund reporting focuses on the determination of operating income, changes in net position, financial position, and cash flows. The proprietary fund category consists of enterprise funds and internal service funds.

12.6 SELF ASSESSMENT QUESTIONS

1. What points would you bear in mind in conducting an investigation on behalf of an individual proposing to buy a running trading concern?
2. What is an Investigation? Mention some of the purposes which may necessitate investigation of accounts of a business.
3. The term investigation implies an examination of accounts and records some special purposes.
4. What is investigation? Explain about the various features of investigation.
5. Describes the investigation on behalf of the companies act, 2013.
6. Write short notes on :
   a) Powers of Investigator
   b) Position of Investigator
   c) Duties of Investigator
   d) Investigators Report.

12.7 REFERENCE BOOKS

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Dr. VISHNU VADDE

LESSON –13
PRINCIPLES AND STAGES OF INVESTIGATION

OBJECTIVES

After studying this lesson student should be able to:

- To understand the guiding principles of investigation.
- To study the stages of investigation.
- To know the procedure for Investigation.

STRUCTURE

13.1 Introduction
13.2 Principles of Investigation
13.3 Principles of Forensic Accounting and Investigation Standards
13.4 Stages of Investigation
13.5 Procedure followed for conducting Investigation Audit.
13.6 Summary
13.7 Technical Terms
13.8 Self Assessment Questions
13.9 Reference Books

13.1 INTRODUCTION

Sometimes students get an impression that auditing and investigation mean the same thing. But there is a lot of difference between the two as we shall see in the following discussion.

Investigation means a searching enquiry into the accounts of a business for a special purpose. In the words of an eminent author, "Investigation involves enquiry into facts behind the books and accounts into the technical, financial and economic position of the business or organization." An investigation implies something more than the verification of the accuracy of the figures of the balance sheet. In short, the term investigation may be described as special audit.

The professions of Forensic Accounting and Investigations (FAI) are highly specialized practice areas which require special emphasis to certain aspects of attributes and performance for professionals practicing in these domains. The Digital Accounting and Assurance Board (DAAB), a non-standing Committee of the Institute of Chartered Accountants of India (ICAI), is issuing a set of Forensic Accounting and Investigation Standards (FAIS) to standardize the work undertaken by its members in this area. A separate document titled "Framework Governing Forensic Accounting and Investigations" defines FAI as well as provides an overview of these Standards.

In conducting FAI assignments, there are a set of core principles fundamental to the profession and the activities undertaken by the professionals. These "Basic Principles" of forensic accounting and investigations, as outlined in this document, are critical to achieve the desired objectives.

With these basic principles, the stakeholders at large will have a point of reference to draw expectations of work undertaken, procedures performed, record keeping and reporting for Forensic Accounting and Investigation engagements.

All FAI engagements shall be performed based on these basic principles, and departures from these principles shall be appropriately disclosed in any assignment report or other similar communication issued by the FAI professional.

13.2 PRINCIPLES OF INVESTIGATION

The receipt and investigation of complaints should be conducted with due regard to a number of key principles. Each of these is important. However, extensive consultation suggests that the first three - confidentiality, anonymity and safety/ welfare needs – are particularly so, as the making of a complaint and giving of evidence can render a witness vulnerable to reprisal. In extreme cases the witness' survival might be under threat. This being the case, it is incumbent upon the agency to do all in its power to protect witnesses and to promote their safety and welfare: These Guiding Principles were developed to assist investigators and enhance the quality of workplace investigations.

13.2.1 Confidentiality and Privacy

The investigator should take steps to safeguard the confidentiality of the investigation without guaranteeing anonymity or complete confidentiality. Complainants, witnesses and subjects of a complaint have a right to confidentiality. In some instances it will not be possible to guarantee confidentiality e.g. where referral is made to national authorities, or where the witness' identity will be readily inferred. In such cases the guiding principle should be that of 'informed consent." Information needs to be shared on a 'need to know' basis with the parameters of this being established at the planning stage. The identity of those involved should only be disclosed on an authorized basis where referral to national authorities is indicated. Within the disciplinary process it would not normally be necessary or desirable to reveal the identity of complainant, victim or other witnesses. Records should be stored securely to avoid accidental or unauthorized disclosure of information.

13.2.2 Anonymity

The fact that a complaint is made anonymously does not automatically mean that it bears less substance than one in which the complainant identifies himself/herself and is prepared to give evidence. It may indicate fear of reprisal. This being the case, anonymous complaints should be treated as seriously as 'named' complaints - though the extent to which they can be investigated may be circumscribed by the anonymity. Consideration needs to be given as to how an anonymous referral might be facilitated.

13.2.3 Professional care and competence

All those involved have due training, skills and knowledge to fulfill their responsibilities. A training strategy will need to be developed to address the training needs of investigators, managers and human resources staff. The competence of all involved must be subject to review within supervision and annual appraisals.

13.2.4 Thoroughness

Investigations must be conducted in a diligent and rigorous manner to ensure that all relevant evidence is obtained and evaluated (including evidence which might both support or refute the complaint).

13.2.5 Independence

It is essential that investigators have no personal or professional interest in the people implicated or the project. This will require the creation of a pool of qualified investigators. Planning and review - to ensure that investigations are planned, systematic and completed according to agreed timeframes.

13.2.6 Respect for all concerned

Respect for all concerned including the subject of the complaint. All concerned have the right to be treated with respect and dignity and to be kept informed of the progress of the investigation.

13.2.7 Timeframes

It is in everyone's interest that investigations are conducted as quickly as possible without prejudicing quality. A number of factors (communication systems, travel, distance etc.) will influence what is a reasonable timeframe. However, as a general rule, investigations should be complete (i.e. final report submitted) within 28 days of receipt of complaint.

13.2.8 Working in partnership with other interested parties

In some cases other INGOs or NGOs might be implicated in the complaint. In such instances, consideration needs to be given to conducting a joint investigation in the interests of sharing relevant information and obviating the need for repeated interviews.

13.2.9 National authorities

In any case in which a crime appears to have been committed, consideration needs to be given to informing national authorities. This can be a very challenging decision if there are doubts as to the integrity of police/legal systems. The decision to inform the authorities should be taken by the designated senior manager.

13.2.10 Decision to Conduct an Investigation

An investigator should consider initiating an investigation when indicated by law, policy, or practice.

13.2.11 Choice of Investigator

The investigator should be impartial, objective, and possess the necessary skills and time to conduct the investigation.

13.2.12 Scope of Investigation

The investigator should develop a mutual understanding of the scope of the investigation, meaning the issues to be investigated.

13.2.13 Investigation Planning

The investigator should engage in planning for an effective investigation.

13.2.14 Evidence Gathering and Retention

The investigator should gather relevant evidence.

13.2.15 Witness Interviews

There are many effective ways to conduct witness interviews. The investigator should create an environment that maximizes the likelihood of obtaining reliable information and should document (either through note taking and or recording or some other method) the witness' statements in a reliable and consistent fashion.

13.2.16 Documenting the Investigation

The investigator should document the steps taken during the investigation, the evidence collected, and the investigator's decision-making process, so that there is a reliable record to support the investigator's findings.

13.2.17 Investigation Findings

The investigator's findings should be consistent with the scope of the investigation.

13.2.18 Reports

If requested by the clients, the investigator should provide a report to the client at the conclusion of the investigation.

Good investigations are based on eight fundamental principles.

1. Investigators must be as independent as possible.
2. Investigators must be trained and experienced.
3. All potentially relevant issues must be identified and, where appropriate, pursued.
4. Investigations must be sufficiently resourced.
5. All relevant physical and digital evidence must be identified, preserved, collected and examined as necessary.
6. All relevant documentation must be secured and reviewed.
7. All relevant witnesses must be identified, segregated where practical and thoroughly interviewed.
8. The analysis of all the material gathered during the investigation must be objective and based solely on the facts.

12.3 PRINCIPLES OF FORENSIC ACCOUNTING AND INVESTIGATION

India as a nation has traditionally struggled with having a well-structured financial market. This was also the reason for many scams which happened mainly because of the loopholes in the system. However, things have been changing in the last decade as the governments have looked proactive in bringing reforms to cut down the loopholes and make the system more streamlined. Notable reforms in such category are to bring standard for Forensic Accounting and Investigation to streamline the process of examining possible frauds. This will greatly help the companies providing finance and accounting outsourcing services.

FDI or foreign direct investment in India has grown tremendously in recent times. To promote the investments the government is bringing a lot of reforms to the economic sector. Riding on the wave of reforms, the Institute of Chartered Accountants of India has started developing the first-ever standards for Forensic Accounting and Investigation to tackle the inadequacy led by the lack of a uniform process for forensic accounting and investigation. This reformist move by the ICAI to possess a set standard has come at a time when instances of forensic accounting and investigation assignments linked with ascertaining facts in company's or banking related frauds are on the rise. It is a no brainer that these standards will eliminate the flaws in the systems to prevent these frauds from happening.

In the following sections, we will understand in brief about what is foreign accounting and investigation and follow it up with the process of setting the standards and principles governing these standards. We will also understand in brief about the various know hows of conducting an investigation as per the standards.

13.3.1What is Forensic Accounting and Investigation

Forensic accounting means the methods of studying and evaluating the evidence of an account of a company or entity by individuals who are proficient in finding any misfits in the data. This is usually done to expose or investigate any fraud that has happened in the company. Forensic accounting is also a measure of means to interpret and to assert the findings suitable for producing in a court during law proceedings. Forensic accounting relates to the world of monetary transaction and operational arrangements. Investigation means a critical and systematic examination of facts, records, documents, and records for a selected purpose. The purpose is usually to seek facts and figures to be presented before a Court to expose how the fraud was undertaken by the party in question.

There are companies out there with expert professionals who can carry out the investigation in a time bound and professional manner. However, to streamline the whole process of investigation the standards have been set which act as a guideline for the investigators to identify frauds. Earlier, confusions used to arise because of a lack of standards for the investigation of such cases which made the processing of cases time-consuming. Sometimes, due to this, the evidence was tempered leading to false results. With the new standards in place, all these issues have been avoided.

13.3.2 Governing Principles of FAIS

The Institute of Chartered Accountants of India has devised the following principles to govern the FAIS:

a. **Independence and Neutrality**: This is an obvious principle that during the investigation, an investigator should take on the procedures with complete neutrality and independence of thought. He/she should be unbiased and approach the investigation objectively.
b. **Quality and Continuous Improvement**: With each case, there must be an improvement in the way a case is approached, and the quality standards must be maintained.
c. **Integrity and Objectivity**: Investigators must approach the given case with complete integrity and objectivity any inherited bias.
d. **Confidentiality**: This is one of the most important aspects of the investigation. Because the parties in question are generally big businesses, any mismanagement on this part could seriously hurt the reputation of the business. Hence, the FAIS must be carried out by maintaining 100% confidentiality.
e. **Professional Care**: The investigation must be carried out in a fully professional manner. Value to time must be given and unnecessary questioning or procedures should be avoided.
f. **Skills:** The skills of the investigators' matters and thus the most qualified individual should provide these services.
g. **Respecting Rights and Obligations:** While investigating or accounting, a professional must mind the rights of the party and his/her own obligations to avoid any conflict.
h. **The Primacy of Truth:** Finding the truth must be the top priority for the professional. It should be given precedence in any case.

i. **Segregating Facts from Opinion**: A professional must have the ability to verify an opinion. The results must only contain data based on facts rather than opinion. Separating facts from opinion is the key.

13.4.1 STAGES OF INVESTIGATION

As investigation involves a variety of situations, it is not possible to my own standardised procedure. However, usually, an investigation requires the following steps in order of sequence:

13.4.1 Determination of Objectives and Establishment of Scope of Investigation

At the stage of acceptance of the assignmentthe investigator should be absolutely clear about what is sought to be achieved by the investigation. If instructions from the client leave matters vague and non-specific, it would be proper for the investigator to have the matters discussed and obtain clearly written instructions covering the object and the scope of investigations and the issues incidental thereto.

The period that the investigation should cover should be clearly specified. The results of the investigation are often seriously affected owing to changes in circumstances which have occurred since it was contemplated, e.g., devaluation, import restrictions, starting of a new division, etc. Therefore, the purpose of the investigation should be borne in mind while determining the period that an investigation should cover.

13.4.2 Formulation of the investigation programme

It is not possible to draw up one programme to serve different types of investigations that a professional accountant is called upon to carry out for their scope and content have to be determined on a consideration of circumstances peculiar to each business or situation.

The investigation programme should be drawn up having regard to the nature of the business, the instructions from the client embodying the objectives, the consequent scope and depth and the necessity to extend the investigation into books and records belonging to others. The programme should also be flexible so that knowledge gained with the progress of work can be used to extend, reduce or modify the extent and areas of checking.

In programming the verification, the investigator should concentrate on areas considered relevant rather than undertake a wide-ranging verification. For example, in an investigation on suspected payment of wages to ghost workers, the investigator should scan the areas having a bearing on the determination of wages and payments thereof. He should concentrate on time and job cards, appointment and termination of workers, attendance records, internal controls, internal checks, preparation of wage sheets, withdrawal of money from the bank for payment of wages and the actual disbursement of wages.

A conscious effort in investigation programming should be devoted to localise the enquiry into the relevant areas and, for that purpose, the initial wider base of inquiry should be gradually narrowed and fixed at a level that is meaningful. Matters not found to have a bearing on the subject matter of investigation should be gradually and progressively eliminated. This procedure alone will enable an in-depth examination of the matters relevant to the investigation.

13.4.3 Collection of Evidence

Through examination, the investigator would be gathering relevant evidence connected with the matters to be investigated. In the course of the examination of the documents and records, the investigator may require to obtain oral explanations from various personnel of the concerned business. In case his client is a person external to the business, it may be necessary for the investigator to get the matter formally agreed to by the business through the client.

The investigator should look for the most convincing evidence; he should seek and examine all the available evidence and by a process of elimination and corroboration, should endeavour to reach the truth of the matter. He, unlike the auditor, is not to restrict himself to prima facie evidence ordinarily available. He should examine it and if circumstances demand should try to obtain evidence that may have to be specifically procured.

For example, in the matter of valuation of land, he should definitely have regard to the available evidence as per records of the business and records of any bid received for the land. In addition, he should have regard to the prices at which land was sold or purchased in the neighbourhood around the same time. This may require him to obtain evidence even by going to the land registration office. He may also call for the report of experts in land valuation.

13.4.4 Analysis and Interpretation of Findings

Careful analysis and correlation of facts and figures will be necessary before the investigator can reach his conclusion. The conclusion should be well-reasoned and backed by established facts and data. He must analyse the data objectively on the basis of evidence gathered by him and should not draw conclusions according to preconceived notions. While interpreting the figures, the investigator must keep in mind various factors e.g. the political and economic considerations, the competition faced by the business, the historical pattern of the data, the nature of the business, etc.

13.4.5 Reporting of findings

Like all other work of an accountant, an investigation results in a report. It is submitted and addressed to the party at whose instance the investigation has been carried out. The nature of the report is governed mainly by two factors. First, the instructions given by the client as regards the special aspects of the business which are required to be investigated; and second, the findings of the investigating accountant.

13.5 PROCEDURE FOLLOWED FOR CONDUCTING INVESTIGATION AUDIT

The basic procedure and scope as followed by Investigation Auditor(IA) is givenbelow:

Observations: Investigation into various areas and records of the company led to following observations

a) **Salary & Wages:** Salary and wages related records and documents, for the period under scrutinized and following discrepancies were noted:
    i. The registers maintained for recording the attendance of various employees were scrutinised.It was found that many names appearing there in were fictitious.
    ii. Signatures/thumb impressions for many employees were found not to be proper.
    iii. Discrepancy with regard to signatures were noted where the same employee's signatures were found to be varying to a large extent.
    iv. It was further noted that the Department Head was not verifying the thumb impressions of number of the employees.
    v. There were many instances where overtimes were reported, which again were not sanctioned, by the Department Head.
    vi. On refusal of the Department Head to ratify the overtime hours to various employees, and if it is doubtful signatures and thumb impressions, the amount of salaries and wages supposedly disbursement to them, his observation

gained further credence when the management was not able to production of these employees for an on-the-spot meeting with the IA.

vii. Some apparent mistakes in the salaries and wages sheets were noted for non – deduction of leaves of some employees, resulting in overstatement of these expenses.

viii. Corresponding cash withdrawals from the bank account were not commensurate to the salary and wages reported to have been disbursed for the same period. Instead, cash disbursals were reported without corresponding cash receipts.

b) **Sales:** On scrutiny of various sales related documents and records, it was noticed that Sales were noted to be understand by adopting following modes of misrepresentation and falsification:

i. Many instances were noted where the goods were issued without invoices.

ii. Production records, dispatches, stock records and sales recorded were correlated to arrive at a detailed list. This was quantified and stated in the IA report as “Amount reported under investigation.”

iii. Some sales invoices were found to be kept blank, with the intention to manipulate the records as a later date.

iv. It was noted in many instances that the sales recorded were at the rates which were less than the approved rate list, thus understanding sales. This too was quantified and stated in the IA report and “Amount reported under Investigation.”

c) **Purchases:** Purchases were noted to be overstated by adopting following modes of misrepresentation and falsification:

i. Purchases were classified into two types – Purchase of fixed assets and Purchases pertaining to consumables and raw material.

ii. Purchases of Fixed Assets: On review of the records related to purchases of capital items like plant machinery, furniture & fixtures, and other items, it was observed that normally established purchase procedures were not followed by the company. Overlooking the established norms quotations were not called for. There were no documents for recording any roving enquiry made in the absence of quotations. Assets purchased in the previous year were taken up for an in-depth study, after it was found that there were no proper procedures in place for purchase of assets. Detailed price lists were obtained from the dealers for these assets and the findings revealed some major discrepancies. It was noted that of the 10major asset purchases made during the year, 6 asset purchases revealed excess payments to the extent of 25 per cent to 40 per cent more than the market rates. All the purchases had approval of the management. Initial Discussion Note preparation by the IA to the management included these findings along with the financial impact. In absence of a satisfactory reply of the management, this observation was stated in the IA report as “Amount reported under investigation.” Excess payments thus released resulted in negative cash flow for the company besides having an adverse impact on the profits of the company by the corresponding increase in the depreciation. The fixed assets register (FAR) was reviewed and it was noted that there was no procedure for codification and regular physical verification of assets. A scrutiny of the financial statements of the company for 3 years was conducted and it was observed that there were regular instances of ‘Assets written off’ and in absence of related physical verification reports and plausible management explanation, it was surmised that these amounts may also be reported by the IA as "Amount reported under investigation." This view was strengthened by an adverse report form a technical expert, whose opinion was sought regarding the period of usage, normal wear and tear and the regularity of assets written off by the company.

iii. Purchase of consumables and raw materials: Physical verification of stocks was conducted on commencement of the inquiry and the basis of valuation adopted over a period of time was verified. The variation over the years in valuation of stock held was not supported by a corresponding change in prices and this was attributed to incorrect valuation. The valuation was checked with the purchase invoices market prices, some fictitious purchase invoices were found to be booked to overstate the purchase of raw material. A correlation between raw material purchased and consumed was conducted with the production records. It was found that production figures after accounting for normal wastage were at variance with the raw material consumption figures. This led to a situation where large amount of raw material supposed to have been purchased was being depicted in the books. However, on conducting physical verification of the same there was no related stock in hand. An independent opinion from a technical expert was obtained which corroborated the IA report findings. It was thus reported that purchases were overstated to the extent mentioned in IA report as "Amount reported under investigation."

13.6 SUMMARY

It can be seen that an impartial investigation is generally conducted so that an employer can determine what occurred when there are contested allegations affecting that involve a potential violation of an investigator's policies, standards, ethics, or the law. The point of an impartial investigation is to provide a fair and impartial process for the complainant and respondent and to reach reasoned findings based on the information gathered. The investigator should prepare general lines of inquiry to be addressed during witness interviews. There have been significant legal developments regarding proper confidentiality instructions to witnesses. These developments should be considered. These Guiding Principles were developed to assist investigators and enhance the quality of investigations.

The Forensic Accounting and Investigation Standards aims to be principle-based instead of rule-based, thus enabling enough space for professional's judgement while applying such principles.The standards always assert that the spirit of the law should prevail over the letter of law. The standards lay down a minimum set of requirements that are ought to be followed by every ICAI members and is additionally recommended to other professionals as well.

Due to the nature of FAI assignments, it is critical to obtain and understand the views and standpoint of all parties. Ample opportunity shall be given to all parties to present their evidences and perspectives. This however should be done at the right time and in the right manner, such as through written communication, for e.g., show-cause notice, written explanation etc. All FAI engagements need to adhere to the law, including laws of privacy, to the suspect. No conclusion should be drawn without following the principles of natural justice which give the other party full right to be heard with opportunity to present their version of the truth.

The FAI engagement is predominantly a fact-finding exercise. FAI professionals shall ensure that their personal judgement and biases find no place in this exercise. Personal perspectives shall be segregated from professional judgement, which in turn shall not be clouded by contamination or noise in the evidence. This is particularly important when interviewing a witness or suspect. An accounting and investigation professionals shall ensure that an assessment mechanism is in place to monitor performance of self and subordinates and also, any external experts on whom reliance is placed to complete some part of the assignment. A peer review mechanism for quality control shall be followed to adhere to all aspects of the pronouncements issued by the ICAI.

In this lesson we have discussed the progression of the investigative process and the key elements within the progression that must be considered by an investigator. These elements within the investigative process are the signposts on the roadway of a mental map. These signposts of active event or inactive event tell us to either take action within the extended authorities of exigent circumstances or to modify our response for an inactive event and recognize the need to make the transition to a strategic response. An investigator's understanding of the changes in circumstances that define these situations and the change from active to inactive events can make the difference between successful and unsuccessful investigative outcomes.

13.7TECHNICAL TERMS

Independent Auditor's Report: The independent auditor's report is a formal letter to communicate the results of the audit. The report will also include the auditor's opinion on the financial statements and whether they are presented fairly in accordance with generally accepted auditing standards (GAAP) or the other comprehensive basis of accounting that is applicable.

Forensic Accounting: The overriding objective of Forensic Accounting is to gather facts and evidence, especially in the area of financial transactions and operational arrangements, to help the professional form an independent expert view (but not to express a professional opinion) and support a legal case in the court of law.

DAAB: The Digital Accounting and Assurance Board (DAAB), a non-standing Committee of the Institute of Chartered Accountants of India (ICAI), is issuing a set of Forensic Accounting and Investigation Standards (FAIS) to standardize the work undertaken by its members in this area.

Fraud: Fraud is any intentional or deliberate act to deprive another of property or money through deception or other unfair means. As per prevailing legal provisions in India, one does not need to demonstrate whether or not there is any wrongful gain or wrongful loss for the fraud to occur.

Litigation: Litigation is a process of handling or settling a dispute in a court of law or before a regulatory body. Litigation would include alternative dispute resolution mechanisms.

Investigation: A critical examination of evidences, documents, facts and witness statements with respect to an alleged legal, ethical or contractual violation. The examination would involve collection, documentation, evaluation to portray the facts of the alleged violation with an expectation that the matter might be brought to a court of law or a regulatory body.

Proprietary Fund: Proprietary fund reporting focuses on the determination of operating income, changes in net position, financial position, and cash flows. The proprietary fund category consists of enterprise funds and internal service funds.

Compliance Audit: A program-specific audit or an organization wide audit of an entity's compliance with applicable compliance requirements.

Due Professional Care: Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent person in a similar circumstance. Due professional care is exercised by auditors when they conduct their audits in accordance with the applicable auditing standards.

Engagement Letter: The engagement letter documents the agreed-upon terms of the audit between the auditors and those charged with governance. The agreement should include the objective and scope of the audit, the responsibilities of the parties involved the timing of the audit, and the expected form and content of reports that will be issued by the auditor.

Audit Plan: A description and schedule of audits to be performed over a certain period of time (typically three years); includes areas to be audited, type and scope of work, and high-level objectives.

Audit Program: Policies and procedures that govern the audit process

Controls: Methods that preserve the integrity of important information, meet operational or financial targets, and/or communicate management policies

Internal Audit: The process of providing independent assurance that an organization's risk management, governance, and internal control processes are operating effectively

Effective Date: These Basic Principles are applicable for all engagements beginning on or after a date to be notified by the Council of the ICAI.

IA: Investigation Auditor
FAR: The Fixed Asset Register
FAIS: Forensic Accounting and Investigation Standards
ICAI: The Institute of Charted Accountants of India
PVA: Physical Verification of Assets
IDNP: Initial Discussion Note Preparation
GAAP: Generally Accepted Account Principles
GAAS: Generally Accepted Auditing Standards
AC: Accounting for Contingencies

13.8 SELF ASSESSMENT QUESTIONS

1. What do you understand by Investigation?
2. What are the guiding principles of Investigation? Explain.
3. Discuss the principles of Forensic Accounting and Investigation Standards.
4. Discuss the various stages in Investigation.
5. Map out the investigation. The first step involved in investigative accounting is preparation.

6. What is Investigation? State the procedure followed for Investigation Audit.
7. Write short questions on:
   a) Good principles of Investigation
   b) Documentary Evidence
   c) Investigation Report

13.9 REFERENCE BOOKS

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5. **Walter W.Bigg**, 'Spicer and Pegler's Practical Auditing', Allied Publishers (P), Bombay, 1965.
6. **SK Basu,** 'Auditing Principles and Techniques', Pearson Education in South Asia, 2006.
7. **Philip L Deflies, Kenneth P.Johnson, and RodickK.Macleod**, 'Montgomery's auditing', Ronald Press Co, New York, 1939.
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Dr. VISHNU VADDE

LESSON – 14
REPRESENTATION BY MANAGEMENT

OBJECTIVES

After studying this lesson student should be able to:

- To state the representation by management as audit evidence
- To know the documentation of representation by management.

STRUCTURE

14.1 INTRODUCTION

Management representation is a letter issued by a client to the auditor in writing as part of audit evidences. The representations letter must cover all periods encompassed by the audit report, and must be dated the same date of audit work completion. It is used to let the client's management declare in writing that the financial statements and other presentations to the auditor are sufficient and appropriate and without omission of material facts to the financial statements, to the best of the management's knowledge. It serves to document management's representations during the audit, reducing misunderstandings of management's responsibilities for the financial statements.

For audit evidence, it is reliable if the auditor has no other means of obtaining evidence. Examples may include situations involving contingent liabilities or off-balance-sheet liabilities. The person issuing the letter should have the appropriate authority or seniority in the organization to vouch on the issue.

In the case of contradictions between other sources of evidence and management representations, the auditor should conduct further investigations.

14.2 REPRESENTATION BY MANAGEMENT AS AUDIT EVIDENCE

ISA (UK) 580 asserts that, although written representations provide necessary audit evidence, they support other audit evidence obtained and do not on their own provide sufficient appropriate audit evidence about any of the matters with which they deal. Where no other evidence is available, it could lead to a qualification to the auditor’s report because of a limitation of scope.

This also applies to cases where there is a genuine limitation of scope and the auditor does not expect any other evidence to be available. For example, where the auditor is appointed after the end of the reporting period and is unable to find any means of verifying material quantities of stock, management representations could never be considered sufficient evidence on their own to support quantities.

There will, however, be instances when no supporting evidence is available and cannot reasonably be expected to be available, and where written confirmation of the representation, when taken into consideration with other information of which the auditor is aware, will constitute sufficient evidence. For example, when auditing a deferred tax provision, the auditor may need to accept representations about management's intentions in regard to future capital spending. Similarly, the classification of financial instruments may depend on management's intentions regarding the use of the instrument. In such cases, the auditor should ensure that nothing conflicts with the representations and that they are consistent with other evidence obtained during the course of the audit regarding management's plans and intentions.

This section establishes a requirement that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with the standards of the PCAOB and provides guidance concerning the representations to be obtained.

14.2.1 Reliance on Management Representations

During an audit, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit. Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations.

The auditor obtains written representations from management to complement other auditing procedures. In many cases, the auditor applies auditing procedures specifically designed to obtain evidential matter concerning matters that also are the subject of written representations. For example, after the auditor performs the procedures described in AS 2410, Related Parties, the auditor should obtain a written representation that management has no knowledge of any relationships or transactions with related parties that have not been properly accounted for and adequately disclosed. The auditor should obtain this written representation even if the results of those procedures indicate that relationships and transactions with related parties have been properly accounted for and adequately disclosed. In some circumstances, evidential matter that can be obtained by the application of auditing procedures other than inquiry is limited; therefore, the auditor obtains written representations to provide additional evidential matter. For example, if an entity plans to discontinue a line of business and the auditor is not able to obtain sufficient information through other auditing procedures to corroborate the plan or intent, the auditor obtains a written representation to provide evidence of management's intent.

If a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statements is appropriate and justified.

14.2.2 Obtaining Written Representations

Written representations from management should be obtained for all financial statements and periods covered by the auditor's report. For example, if comparative financial statements are reported on, the written representations obtained at the completion of the most recent audit should address all periods being reported on. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. The auditor should provide a copy of the representation letter to the audit committee if management has not already provided the representation letter to the audit committee. In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:

i. Financial Statements

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

b. Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.

ii. Completeness of Information

a. Availability of all financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

b. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

c. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

iii. Recognition, Measurement, and Disclosure

a. Management's belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. (A summary of such items should be included in or attached to the letter.)

b. Management's acknowledgment of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.

c. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.

d. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

e. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

f. Information concerning related party transactions and amounts receivable from or payable to related parties, including support for any assertion that a transaction with a related party was conducted on terms equivalent to those prevailing in an arm's-length transaction. Guarantees, whether written or oral, under which the entity is contingently liable.

g. Significant estimates and material concentrations known to management that is required to be disclosed in accordance with the AICPA's Statement of Position 94

iv. Disclosure of Certain Significant Risks and Uncertainties.

a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

b. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5,
c. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5
d. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.
e. Compliance with aspects of contractual agreements that may affect the financial statements.
f. The appropriateness of the methods, the consistency in application, the accuracy and completeness of data, and the reasonableness of significant assumptions used by the company in developing accounting estimates.

v. Subsequent Events

a. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. Examples of additional representations that may be appropriate are provided in appendix B, "Additional Illustrative Representations" [paragraph .17].

Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements, for example, items (*a*), (*c*), (*d*), and (*e*) above. In addition, because of the possible effects of fraud on other aspects of the audit, materiality would not apply to item (*h*) above with respect to management or those employees who have significant roles in internal control.

The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report. [If the auditor "dual dates" his or her report, the auditor should consider whether obtaining additional representations relating to the subsequent event is appropriate.

The letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity.

If current management was not present during all periods covered by the auditor's report, the auditor should nevertheless obtain written representations from current management on all such periods. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. As discussed in paragraph .08, management's representations may be limited to matters that are considered either individually or collectively material to the financial statements.

In certain circumstances, the auditor may want to obtain written representations from other individuals. For example, he or she may want to obtain written representations about the completeness of the minutes of the meetings of stockholders, directors, and committees of directors from the person responsible for keeping such minutes. Also, if the independent auditor performs an audit of the financial statements of a subsidiary but does not audit those of the parent company, he or she may want to obtain representations from management of the parent company concerning matters that may affect the subsidiary, such as related-party transactions or the parent company's intention to provide continuing financial support to the subsidiary.

There are circumstances in which an auditor should obtain updating representation letters from management. If a predecessor auditor is requested by a former client to reissue (or consent to the reuse of) his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, the predecessor auditor should obtain an updating representation letter from the management of the former client. Also, when performing subsequent events procedures in connection with filings under the Securities Act of 1933, the auditor should obtain certain written representations. The updating management representation letter should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest financial statements reported on by the auditor that would require adjustment to or disclosure in those financial statements.

14.2.3 Scope Limitations

Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement.[18] However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate. Further, the auditor should consider the effects of the refusal on his or her ability to rely on other management representations.

If the auditor is precluded from performing procedures he or she considers necessary in the circumstances with respect to a matter that is material to the financial statements, even though management has given representations concerning the matter, there is a limitation on the scope of the audit, and the auditor should qualify his or her opinion or disclaim an opinion.

13.2.4 Effective Date

This section is effective for audits of financial statements for periods ending on or after June 30, 1998. Earlier application is permitted.

Appendix A - Illustrative Management Representation Letter

The following letter, which relates to an audit of financial statements prepared in conformity with generally accepted accounting principles, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and cash flows for the years then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited.

If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred" In appropriate circumstances, item 9 could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: "Except for the allegation discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information.

Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in AS 2401, Consideration of Fraud in a Financial Statement Audit, and related parties, in AS 2410, Related Parties. To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations.

[Date] To [Independent Auditor]

We are providing this letter in connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the [consolidated] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [consolidated] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, [*as of (date of auditor's report),*] the following representations made to you during your audit(s).

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all—

a. Financial records and related data, including the names of all related parties and all relationships and transactions with related parties.

b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[1]
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
    a. Management,
    b. Employees who have significant roles in internal control, or
    c. Others where the fraud could have a material effect on the financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the financial statements:
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the company is contingently liable.
11. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position
12. There are no—
    b. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
    c. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.[2]
    d. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
    e. Side agreements or other arrangements (either written or oral) that have not been disclosed to you.
    f. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
13. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

a. [As amended, effective for audits of financial statements for periods beginning on or after December 15, 1999 by Statement on Auditing Standards No. 89. As amended, effective for audits of financial statements for periods beginning on or after December 15, 2002, by Statement on Auditing Standards No. 99.]

Appendix B - Additional Illustrative Representations

Representation letters ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. The following is a list of additional representations that may be appropriate in certain situations. This list is not intended to be all-inclusive. The auditor also should consider the effects of pronouncements issued subsequent to the issuance of this section.

Condition	Illustrative Specific Written Representation
General	
Unaudited interim information accompanies the financial statements	The unaudited interim financial information accompanying [presented in Note X to] the financial statements for the [identify all related periods] has been prepared and fairly presented in conformity with generally accepted accounting principles applicable to interim financial information. The accounting principles used to prepare the unaudited interim financial information are consistent with those used to prepare the audited financial statement
The effect of a new accounting principle is not known.	We have not completed the process of evaluating the effect that will result from adopting the guidance in Financial Accounting Standards Board (FASB) Accounting Standards Update 20YY-XX, as discussed in Note [X]. The company is therefore unable to disclose the effect that adopting the guidance in FASB Accounting Standards Update 20YY-XX will have on its financial position and the results of operations when such guidance is adopted
Financial circumstances are strained, with disclosure of management's intentions and the entity's ability to continue as a going concern	Note [X] to the financial statements discloses all of the matters of which we are aware that are relevant to the company's ability to continue as a going concern, including significant conditions and events, and management's plans.
Assets	
Management has determined the fair value of significant financial instruments that do not have readily determinable market values.	The methods and significant assumptions used to determine fair values of financial instruments are as follows: [describe methods and significant assumptions used to determine fair values of financial instruments]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.
Financial instruments with off-	The following information about financial instruments with

balance-sheet risk and financial instruments with concentrations of credit risk exist.	off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the financial statements: 1. The extent, nature, and terms of financial instruments with off-balancesheet risk 2. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments 3. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments
Liabilites	
Debt Short-term debt could be refinanced on a long-term basis and management intends to do so	The company has excluded short-term obligations totaling $[amount] from current liabilities because it intends to refinance the obligations on a long-term basis. [Complete with appropriate wording detailing how amounts will be refinanced as follows:] • The company has issued a long-term obligation [debt security] after the date of the balance sheet but prior to the issuance of the financial statements for the purpose of refinancing the short-term obligations on a long-term basis. • The company has the ability to consummate the refinancing, by using the financing agreement referred to in Note [X] to the financial statements.
Tax-exempt bonds have been issued	Tax-exempt bonds issued have retained their tax-exempt status
Pension and Postretirement Benefits An actuary has been used to measure pension liabilities and costs.	We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances.

Appendix C-Illustrative Updating Management Representation Letter

The following letter is presented for illustrative purposes only. Management need not repeat all of the representations made in the previous representation letter.

If matters exist that should be disclosed to the auditor, they should be indicated by listing them following the representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ."

[Date]

To [Auditor]

In connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the [consolidated] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with accounting principles generally accepted in the United States of America, you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [date of latest balance sheet reported on by the auditor] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

14.3 DOCUMENTATION OF REPRESENTATIONS BY MANAGEMENT

The auditor would ordinarily include in audit working papers evidence of management's representations in the form of a summary of oral discussions with management or written representations from management. A written representation is ordinarily more reliable audit evidence than an oral representation and can take the form of: (a) A representation letter from management; (b) A letter from the auditor outlining the auditor's understanding of management's representations, duly acknowledged and confirmed by management; or (c) Relevant minutes of meetings of the board of directors or similar body or a signed copy of the financial statements.

14.3.1 Basic Elements of a Management Representation Letter

When requesting a management representation letter, the auditor would request that it be addressed to the auditor, contain specified information and be appropriately dated and signed.

A management representation letter A management representation letter would ordinarily be dated the same date as the auditor's report. However, in certain circumstances, a separate representation letter regarding specific transactions or other events may also be obtained during the course of the audit or at a date after the date of the auditor's report, for example, on the date of a public offering.

A management representation letter would ordinarily be signed by the members of management who have primary responsibility for the entity and its financial aspects (ordinarily the senior executive officer and the senior financial officer) based on the best of their knowledge and belief. In certain circumstances, the auditor may wish to obtain representation letters from other members of management. For example, the auditor may wish to obtain a written representation about the completeness of all minutes of the meetings of shareholders, the board of directors and important committees from the individual responsible for keeping such minutes.

14.3.2 Action if Management Refuses to Provide Representations.

If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion. In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider if the other implications of the refusal may have any additional effect on the auditor's report.

14.3.3 Example of a Management Representation Letter

The following letter is not intended to be a standard letter. Representations by management will vary from one entity to another and from one period to the next. Although seeking representations from management on a variety of matters may serve to focus management's attention on those matters, and thus cause management to specifically address those matters in more detail than would otherwise be the case, the auditor needs to be cognizant of the limitations of management representations as audit evidence as set out in this ISA.

(To Auditor) (Entity Latter head) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 19X1 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of (present fairly, in all material respects) the financial position of ABC Company as of December 31, 19X1 and of the results of its operations and its cash flows for the year then ended in accordance with (indicate applicable financial reporting framework). We acknowledge our responsibility for the fair presentation of the financial statements in accordance with (indicate applicable financial reporting framework).

We confirm, to the best of our knowledge and belief, the following representations: include here representations relevant to the entity. Such representations may include the following:

- There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements.
- We have made available to you all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors (namely those held on March 15, 19X1 and September 30, 19X1, respectively).
- We confirm the completeness of the information provided regarding the identification of related parties.
- The Company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of noncompliance. There has been no noncompliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of noncompliance.
- The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements:
  - The identity of, and balances and transactions with, related parties.
  - Losses arising from sale and purchase commitments.
  - Agreements and options to buy back assets previously sold.
  - Assets pledged as collateral.
- We have no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements. • We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realizable value.
- The Company has satisfactory title to all assets and there are no liens or encumbrances on the company’s assets, except for those that are disclosed in Note X to the financial statements.
- We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in Note X to the financial statements all guarantees that we have given to third parties.
- Other than described in Note X to the financial statements, there have been no events subsequent to period end which require adjustment of or disclosure in the financial statements or Notes thereto.

- The claim by XYZ Company has been settled for the total sum of XXX which has been properly accrued in the financial statements. No other claims in connection with litigation have been or are expected to be received.
- There are no formal or informal compensating balance arrangements with any of our cash and investment accounts. Except as disclosed in Note X to the financial statements, we have no other line of credit arrangements.
- We have properly recorded or disclosed in the financial statements the capital stock repurchase options and agreements, and capital stock reserved for options, warrants, conversions and other requirements.
-

(Senior Executive Officer) (Senior Financial Officer

14.4 SUMMARY

This we can conclude also applies to cases where there is a genuine limitation of scope and the auditor does not expect any other evidence to be available. For example, where the auditor is appointed after the end of the reporting period and is unable to find any means of verifying material quantities of stock, management representations could never be considered sufficient evidence on their own to support quantities.

Moreover, this section establishes a requirement that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with the standards of the PCAOB and provides guidance concerning the representations to be obtained.

It can be found that require specific written representations that may not be required for every audit. The list is not a substitute for considering the requirements and related application and other explanatory material. In addition, certain AICPA Audit and Accounting Guides suggest written representations concerning matters that are unique particular industry.

14.5 TECHNICAL TERMS

Independent Auditor's Report : The independent auditor's report is a formal letter to communicate the results of the audit. The report will also include the auditor's opinion on the financial statements and whether they are presented fairly in accordance with generally accepted auditing standards (GAAP) or the other comprehensive basis of accounting that is applicable.

Working Papers: Documents that summarize and record all the activities and evidence obtained during an audit or investigation.

Audit evidence: Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information.

Compliance Audit : A program-specific audit or an organization wide audit of an entity's compliance with applicable compliance requirements.

Due Professional Care : Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent person in a similar circumstance. Due professional care is exercised by auditors when they conduct their audits in accordance with the applicable auditing standards.

Engagement Letter : The engagement letter documents the agreed-upon terms of the audit between the auditors and those charged with governance. The agreement should include the objective and scope of the audit, the responsibilities of the parties involved the timing of the audit, and the expected form and content of reports that will be issued by the auditor.

IFAC: International Federation of Accountants
ICAI: The Institute of Chartered Accountants of India
AASB: Auditing and Assurance Standards Board
IAASB: International Auditing and Assurance Standards Board
FASB: Financial Accounting Standards Board.
AC: Accounting for Contingencies
ASC: Accounting Standards Codification
VIEs: Variable Interest Entities
AICPA: American Institute of Certified Professional Accountant
NASBA: National Association of State Boards of Accountancy.
PCAOB: Public Company Accounting Oversight Board
PIOB: Public Interest Oversight Board
ISA: International Standards on Audit
AAS: Auditing and Assurance Standard

14.6 SELF ASSESSMENT QUESTIONS

1. What is Management Representation?
2. Illustrate the representation by management as audit evidence?
3. State the documentation represent by management
4. Discuss the reliance on management representation.
5. Write short answers on:
   a) Audit Evidence
   b) Documentary Evidence
   c) Subsequent Events

14.7 REFERENCE BOOKS

1. **R.G.Saxena and N. Padmalathat**, ‘Principle and Practice of Auditing”, Himalaya Publishing House, New Delhi, 2010.
2. **CA. Kamal Garg, ‘**Professional Approach to Advanced Auditing’,Bhart Law House Pvt. Ldt, New Delhi, 2012.
3. **R. Glynne Williams,** ‘Elements of Auditing’, Institute of Chartered Accountants, London.
4. **Arther W.Holmes and Waynes S. Overmyer**, ‘Basic Auditing ’, D.Irwin Inc, Irwin Dorsey Ltd, USA, 1976.
5. **Walter W.Bigg**, ‘Spicer and Pegler’s Practical Auditing’, Allied Publishers (P), Bombay, 1965.
6. **SK Basu,** ‘Auditing Principles and Techniques’, Pearson Education in South Asia, 2006.
7. **Philip L Deflies, Kenneth P.Johnson, and Rodick K.Macleod**, ‘Montgomery’s auditing’, Ronald Press Co, New York, 1939.
8. **F.R.M.de Paula**, ‘Principle of Auditing’, The English Language Books Society and SIR ISAAK Pitmann and Sons Ltd, London, 1964.

Dr. VISHNU VADDE

Lesson - 15

COMPANY AUDITORS - I

15.0 OBJECTIVES

After studying this lesson you should be able to understand the following.

→ Appointment, removal of an auditor

→ Qualifications, disqualifications of an auditor

→ Remuneration of an auditor

Structure

15.1 INTRODUCTION

Appointment, qualifications, disqualifications, removal and remuneration of an under essentially depend upon the form of organisation. If the audit is governed by a statute, the provisions of the statute will play an important role. A sole proprietary concern is not required, under any statute to get its accounts audited. The auditors of such concerns need not necessarily be qualified professional accountants. In case of partnership business, Indian Partnership Act 1932, does not provided for any compulsory audit. But audit in partnership business facilitate the settlement of accounts, raising loans etc., The statute governing companies provides for compulsory audit of the company accounts sections 224 to 233 of Indian Companies Act, 1956 contain the specific provisions regarding audit. These section deal with qualifications, disqualifications, appointment, reappointment removal status of an audition.

15.2 APPOINTMENT OF A COMPANY AUDITOR

Every company even a private company must appoint an auditor to audit its accounts. The provisions regarding appointment of the auditor are contained in section 224 of the Company Act.

First Auditors : Section 224(5) provides for the appointment of first auditors by the Board of Directors within one month of the date of registration of the company. The auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. Sometimes the first auditors of the company are named in the Articles of Association. Such an appointment of auditors cannot be held valid, since the companies act does not recognise it. In the case of first auditors, it is not a necessary condition under the Act that he shall be improved about his appointment. Similarly, the first auditor is not required to inform the Registrar about the refusal or acceptance of the appointment.

Subsequent Auditors : Subsequent Auditor or auditors of a company are appointed every year by the shareholders in annual general meeting by passing an ordinary resolution. 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 7 days of the appointment give intimation there of to every auditor so appointed. Appointed Auditor should communicate his acceptance or refusal to the Registrar within the period of 30 days of the receipt from the company of the intimation of his appointment.

Appointment by Central Government : According to section 224(3), where at an annual general meeting no auditors are appointed or re-appointed, the central government, may appoint a person to fill the vacancy. Within 7 days of the power of the central government becoming exercisable, company shall gives notice of the fact to the Regional Director, to whom the central government's power to appoint an auditor in such an event has been delegated under section 637.

Appointment Against a Casual Vacancy :

1. If due to death, insanity, insolvency or other disqualification a casual vacancy of the auditor arises.
2. The vacancy arising out of registration of the auditor or his refusal to accept the appointment is not a casual vacancy. The auditor will hold office till the conclusion of next annual general meeting.
3. The Board has no power to fill such vacancy, even if the shareholders' have authorised it in this behalf. Such a vacancy should be filled by the shareholders' in general body meeting.

Appointment by Special Resolution :

According to the Company Act 1974, under section 224-A in the case of company in which 25% or more of the subscribed sharecapital is held. The appointment of an auditor or auditors shall be made by a special resolution.

If the Company fails to pass a special resolution, it shall be deemed that no auditor or auditors had been appointed by the company at its annual general meeting and the central government will be empowered to make an appointment.

Compulsory re-appointment : According to section 224(2), a retiring auditor, by whatsoever, authority appointed, shall automatically reappointed except in the following circumstances -

1. Where he is not qualified for re-appointment.
2. Wher he is unwilling.
3. Where a resolution has been passed not to reappoint.

4. Re appointment of the retiring auditor shall not be made, if he is already holding auditorship in the specified number of companies.

Appointment of Auditors of government or certain other Companies :

The provisions regarding appoint of government companies are different.

1. Section 619 provides that the auditor of a government company shall be appointed or re-appointed by the Central Government on the advice of the Comptroller and Auditor General of India.

2. He may also conduct a supplementary or test audit of such company's accounts by persons authorised by him in this behalf.

3. The auditor should submit a copy of his audit report to the comptroller and Auditor General of India who has the right to Comment on or supplement, the audit report in such manner as he may think fit and the same should be placed in the annual general meeting at the some time and the some manner as the audit report.

15.3 REMOVAL OF AN AUDITOR

No new auditor can be appointed in place of an existing auditor unless the later has been given a due notice according to the company act. According to law if a due notice has not been given, the resolution regarding the removal of the auditor can not be put before the general meeting.

If any shareholder wishes to nominate any other person in place of the existing auditor, he must give a special notice (14 days) to the company. The company mut send a copy there of to the retiring auditor. Such an auditor will have the right to send a representation to the company which in its turn shall send it to the Shareholders. The company may refuse to end such a representation to the shareholders if the court is satisfied on the application of the company. That this right of representation is being misused by the auditor.

The auditor intended to be removed has also a right to attend the general meeting where his removal is to be discussed. He has also a right to speak at such a meeting. The underlying idea is to prevent the directors to remove an auditor without the knowledge of the shareholders.

An auditor can be removed only by the general meeting with the approval of Central Government. The first auditor who is appointed by the directors to hold office till the conclusion of the first annual general meeting may be removed before the expiry of his term by the general meeting even without the approval of Central Government.

For removal of subsequent auditors, besides passing an ordinary resolution, prior permission of the Central Government, must be obtained. Thus it is difficult to remove an auditor before the expiry of his terms since adequate grounds must exist to prove to the Government that the person or the firm sought to be removed in unsuitable for continuing as the auditor.

15.4 QUALIFICATIONS OF THE COMPANY AUDITOR

Section 226 of the Companies Act, prescribes the qualifications and disqualifications of company auditors. According to section 226(i). "a person shall not be qualified as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Account' Act,1949". It further provides that a firm where of all the partners practicing in India are qualified for appointment as auditors may be appointed by firm's name to be the auditor of the company. In this connection, it may be noted that under the Chartered Accountants Act, , only a chartered accountant having a certificate of practice can be engaged in the public practice of the profession of accountancy. Therefore, only a practicing chartered accountant can be appointed as an auditor of a company.

In addition to practicing chartered accountants, section 226(2) allows a holder of a certificate in an erstwhile Part B State which entitled him to act as an auditor of companies in the jurisdiction of that state, to be appointed as an auditor of companies registered anywhere in India.

Disqualification

Section 226(3) provides the disqualifications. According to it following are disqualified to be appointed as auditor of a company –

a. a body corporate;
b. an officer or employee of the company
c. a person who is a partner or who is in 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 indebtness or any third person.
e. a person who by virtue of the above listed provisions is disqualified for appointment as auditor of any other body corporate which is the company's subsidiary or holding company or a subsidiary of that company's holding company or would be so disqualified if the body corporate were a company.

If after this appointment an auditor becomes subject to any of the disqualifications listed above, he shall be deemed to have vacated his office forthwith.

15.5 LIMITATIONS ON AUDITORSHIP

The Companies Amendement Act, added two new sub-sections 1B and 1C. The objective of these sections is to prevent concentration of audits in few hands. The section was further amended in 1988.

According to see, 224 1B, an individual cannot be auditor of more than 20 companies at a time. Further, out of these 20 companies, not more than 10 should be companies having a paid up share capital of Rs.25 lacs or more. In case of a partnership firm of auditors, the ceiling is 20 companies per partner of the firm if a partner is also a partner in any other firm or firm of auditors, the overall ceiling in relation to such a partner will be 20.

Section 224 1B has been amended by the Companies Amendment Act, 1988 to disallow the appointment of persons who are in full time employment elsewhere. Even in case of partnership, such a partner shall be excluded from counting the number of audits per partner.

15.6 REMUNERATION OF AN AUDITOR

According to Section 224 (8):

1. In the case of an auditor appointed by the Board of Directors or the Central Govt. His remuneration may be fixed by the Board or Central Government, as the case may be.
2. In all other cases, it must be fixed by the company in general body meeting or in such manner as the company in general body meeting may determine.

'Remuneration' includes any sums paid by the company in respect of the auditor's expenses in carrying out his duties. Obviously, the general body meeting can disperse without deciding the amount of the remuneration of the auditor. However, it must provide the manner in which the remuneration can be determined.

If an auditor renders services other than the audit work, he will be entitled to separate remuneration for such work. A separate disclosure of all amounts paid to the auditor in whatever capacity, is required to be made in the Profit and Loss Account.

Where an auditor is re-appointed in the next annual general body meeting, the amount fixed for the previous year continues to be the remuneration of the auditor, unless some specific change is made.

15.7 STATUS

Status of an auditor can be observed under three heads -

1. Shareholders Representative
2. Company Officer
3. Company Employee

Shareholders Representative :

An auditor is appointed by the shareholders except in the case of the first auditor of the company who is appointed by the directors during the currency of the year on account of the death of the auditor or by the Central Government in certain cases. It is the right of the shareholdres to appoint an auditor. He is appointed by them to keep a check on the work of the directors, as far as accounts are concern. he is to send a report to the shareholders even though he might have been appointed by them. In case he is appointed by the directors of the Government his remuneration is fixed by the directors or the Government respectively. the shareholdrs may allow him to continue to act as auditor for the next year or may appoint another auditor with the approval of the Central Government. It is they who pay him, of course, out of the funds of the company. The question is whether he is the agent of shareholders or of the directors, or he is an officers of the company, just like the Secretary, Manager, Accountant, etc. Apparently it appears that he perform the functions of an agent as well as that of an officer of the company. Divergent views have been expressed even by the courts. Let us deal with some of these views.

'Lord Cranworth' in the Course of his judgment in the case of Spackman Vs. Evans, said, "The auditors may be agents of the shareholders, so far as it relates to the audit of the accounts. For the purposes of the audit, the auditors will bind the shareholders".

'Lord Chelmsford' said in the same case. "It seems to me that it would be an unreasonable conclusion from the mode of appointment of these officers that they were thereby constituted agents so as to conclude the shareholders by their knowledge of any unauthorised act of the directors".

Company Officer : Auditor is appointed by the company and his position is described in the section as that of an office of the company. He is not a servant of the Directors on the companies, he is appointed by the company to check the directions and for some purposes and the same extent, it seems to me quite impossible to say that he is not an officer of the Company.

Auditor is to be considered as an officer of the company, he will be held liable under sections 477, 478, 539, 543, 545, 621, 625 and 633 of the Companies Act, 1956. These sections refer to the following matters respectively:

a) Power of the Court in winding up to summon persons suspected of having poperty of the company. S.477.

b) Power of the Court to order public examination of persons guilty of fraud, etc., in the promotion, formation or management of the company, S.476.

c) Penalty for the falsification of books, Section 539.

d) Power of the court to assess damages against delinquent officers, Section 545.

e) Prosecution of delinquent officers and members, Section 545.

f) Cognisance of offences under the Act, Section 621.

g) Payment of compesation in case of frivolus or vexatious officers, Section 625.

h) power of the Court to grant relief to officers in proceedings for negligence, default, breach of duty, misfeasance, etc., provided that in a criminal proceeding, the court shall have no power to grant relief from any civil liability which may attach to an officer in respect of such negligence, default, breach of duty, misfeasance or breach of trust, Section 633.

Company Employee : Auditor may be treated as an employee of the Company, because the law, as the ultimate authority provide certain responsibilities to him. He is appointed by the company and he gets remuneration as an employee.

15.9 SUMMARY

Thus an independent professional auditor, with requisite, qualifications and experience conducts the audit of the books of accounts of the company on behalf of the shareholders by throughly examining them and reporting thereon. His appointment, removal, remuneration, qualifications are strictly according to Companies Act 1956. Except first auditors, auditors are appointed by the Shareholders in general meeting. Remuneration has been fixed by the authorities according to Act. Audit is considered not only representative of the Shareholders but also an officer of the company. In some cases he may be treated as an employee of the Company.

15.10 SELF ASSESSMENT QUESTIONS

Five Marks Questions

1. Qualificaitons of an auditor.

2. Disqualifications of an auditor.

3. Removal of an auditor.

Ten Marks Questions

1. What is the procedure to reappoint an auditor.

2. Explain status of an auditor.

3. How the remuneration of an auditor is fixed?

Twenty Marks Questions

1. What is the procedure to appoint an auditor.

2. Explain qualifications and disqualifications of an auditor.

15.11 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr.K.Kanaka Durga

Lesson 16

Company Auditors - II

16.0 OBJECTIVE

After studying this lesson you should be able to understand the following.

→ What are the Rights of an auditor.

→ What are the duties of an auditor.

→ What are the liabilities of an auditor.

Structure

16.1 INTRODUCTION

Auditors require certain rights and powers to do their duty honestly and justify their authority. Non-company auditor is free to determine his rights and duties with the organisation he agrees to audit. A Company Auditor cannot have this flexibility. The law binds him with certain duties and liabilities along with bestowing certain rights and powers.

16.2 RIGHTS OF AN AUDITOR

The rights are statutory ones and cannot be avoided or curtailed in any way by any resolution or even under a provision in the Articles of Association. following are the rights of an auditor.

1. Right of Access to Books and Vouchers

According to section 227(1) provides that "every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the Company, whether kept at the head office of the Company, or else where". Books of accounts include the financial, statutory and statistical books. Voucher includes all documents, correspondence, agreement, etc., which support any of the transactions or date disclosed in the financial statement, directly or indirectly.

2. Right to call for information and explanation

He has got a right to ask the directors and officers of the company to give any information and explanation of his duty as auditor [sec 227(1)]

3. Right to receive notice and attend general meeting

Auditor has a right to receive a notice of and attend every general meeting. He has a right to speak at such meeting when the accounts are being discussed [sec 231]. An auditor, however, must attend the general meeting in the following circumstances :

i. where he has reasons to believe that the directors may deliberately attempt to conceal a serious state of affiars from the shareholders;

ii. when his audit report contains significant qualifications directly affecting the management, so that his remarks may not be misinterpreted or misunderstood;

iii. when he recieves a notice form the company showing that someone else is going to be proposed for appointment in his place;

iv. where he has been specially asked by the management to be present;

v. where any 'material' mater has come to his knowledge subsequent to his signing the report and would have made his report differently if he had known it before signing the report; and

vi. where the accounts have been altered after the report was appended to the account.

4. Right to make a statement at the general meeting

He has a right to make any statement or explanation he desires at such a meeting in connection with the accounts. If he finds that some wrong statements have been made by the directors relating to the accounts he has the right to correct it.

i. The company auditor thus shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor, and

ii. Shall have a right of access at all times to the books and vouchers of the company maintainede at the branch office.

5. Right to Visit Branches

The auditor of a compnay has the right to visit to branches of the company to audit the accounts. If the company is a banking company and has branches outside India the auditor with have no right to visit such branches but will have the right to access to all the returns sent by the branches to the head office [sec 228]

1. The company auditor thus, shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor, and

2. Shall have a right of access at all times to th ebooks and vouchers of the company maintained at the branch office.

6. Right to take legal and technical Advice

He has the right to take expert or technical advice but he must give his opinion in the report and not that of the experts. (Re London and General Bank 1895)

7. Right to Remuneration

An auditor has the right to have his remuneration.

8. Right to Sign the audit report

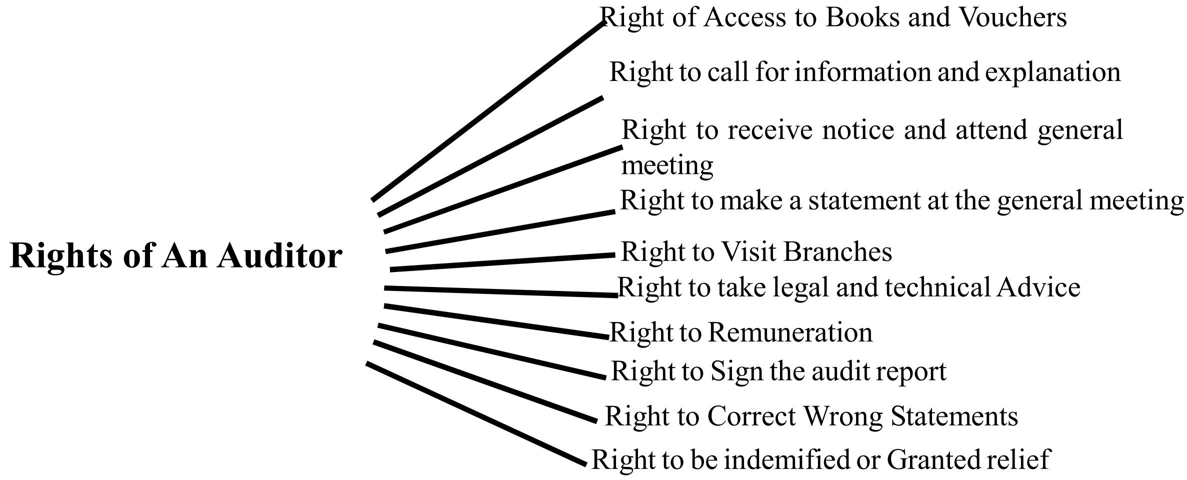
Only the person appointed as auditor of the company may sign the audit report [Sec 229].

9. Right to Correct Wrong Statements

Auditor not only acts as an agent of the shareholders or an officer of the company for limited purposes but also as an observer of law. As an observer he has the right to advice the directors to amend their faulty system of accounts and, if not followed, to report the inadequency of the method of accounts by specifying that the proper books of accounts have not been kept by the company. He can also comment on and correct the wrong statements if any, made by the directors.

10. Right to be indemnified or Granted relief

In terms of Sec.633, an auditor has a right to be indemnified against any liability incurred by him in defending himself agianst any civil or criminal proceeding by the company, provided it is proved to the satisfaction of the Court that he has acted honestly.



16.3 DUTIES OF AN AUDITOR

The duties of an auditor correspond and must necessarily be so with the objectives of audit in hand. The end product of an audit is the auditor's report. Thus, making a report to the members on the accounts of the company becomes the first and foremost duty of an auditor though this duty itself cannot be performed unless he examines and enquires about the various aspects of accounts as well as the mode of keeping these. The law also seeks to ensure that all his legal duties be within his power and justify his profession. Inspite of many provisions in law on this subject there are certain misgivings and unsolved quieries regarding the extent of liability relating to these duties.

In short his duties can be divided into two categories:

1. concerning his work 2. regarding his reporting to members.

16.3.1 Duties Concerning his Work

Section 227(1A) stipulates that it is the duty of the auditor to inquire as follows.

a. Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company or its members.

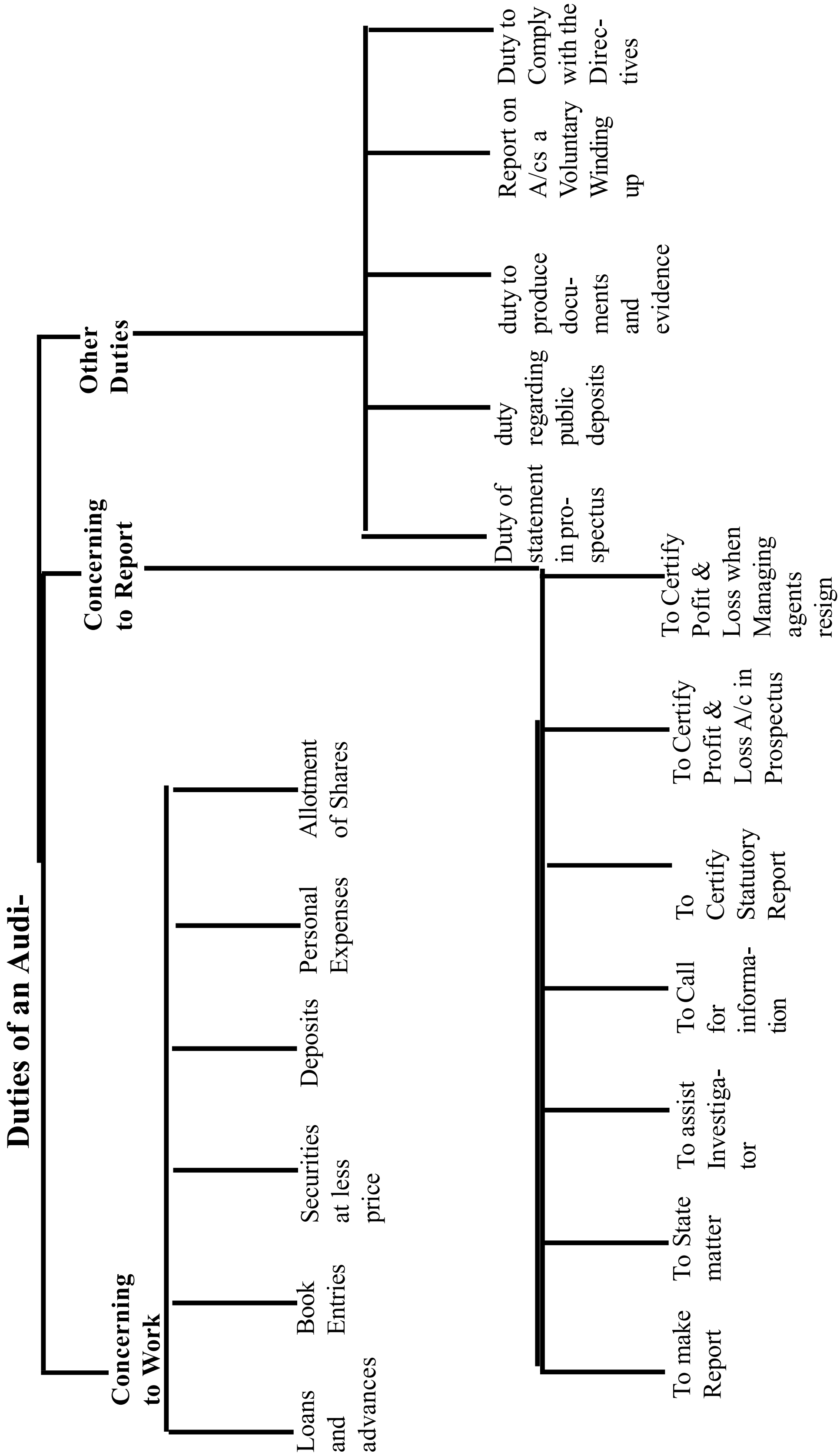
b. Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.

c. Where the company is not an investment company within the meaning of Sec.372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

d. Whether loans and advances made by the company have been shown as deposits.

e. Whether personal expenses have been charged to revenue accounts.

f. Where it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, or if no cash has actually been so received, whether the position is stated in the account books and the Balance Sheet is correct, regular and not misleading.


Duties of an Audi-
Concerning to Work
Loans and advances
Book Entries
Securities at less price
Deposits
Personal Expenses
Allotment of Shares
Concerning to Report
To make Report
To State matter
To assist Investiga-tor
To Call for informa-tion
To Certify Statutory Report
To Certify Profit & Loss A/c in Prospectus
To Certify Pofit & Loss when Managing agents resign
Other Duties
Duty of statement in pro-spectus
duty regarding public deposits
duty to produce docu-ments and evidence
Report on A/cs a Voluntary Winding up
Duty to Comply with the Direc-tives

16.3.2 Duties of an Auditor Regarding his reporting to members

a. Duty to make report : An auditor is appointed to keep a check on the directors. He is the agent of the shareholders to examine the accounts maintained and supervised by the directors and to report to them whether the directors have properly maintained the accounts Spacknman vs Earns 1868. But it is not the duty of an auditor to see that his report has been sent or plced in the hands of the shareholders. After having signed his report and the Balance Sheet and having sent it to the secretary of the company his duty is over as was held in Re Allen Craig & Company, London Ltd. in 1934.

b. Matters to be stated in the report: Whether he was obtained all the information and explanation for the prupose of his audit, whether in his opinion the Profit and Loss Account and Balance Sheet referred to in his referred report exhibits a true and fair view of the profit or loss and state of affairs of the company whether proper books of accounts as required by law have been kept by the company whether he has been forwarded the branch accounts audited by other than the company's auditor to prepare his audit report under [sec 228(3)C] whether the Balance Sheet and Profit and Loss Account have been drawn up according to the requirements of the company act under sec 211.

c. Duty to assist Investigators : It is the duty of an auditor to assist the inspectors in every possible way when the affairs of the company are being investigated [sec 240(5)(6)]

d. It is the duty of an auditor to call for information on various points such as (a) whether loans have been properly secured. (b) whether the shares, debentures securities etc., have been sold at what price (c) whether the personal expenses have been charged to revenue account etc.

e. Duty ot certify the statutory report : He has to certify the statutory report as correct according to [sec 165]

f. Duty to certify Profit & Loss A/c. in Prospectus : The prospectus issued by an existing company should contain a statement with regard to profits and losses and assets and liabilities of the company and its subsidiaries. the auditor has to certify such statement in the prospectus.

g. Duty to certify Profit and Loss A/c when Managing Agents resign : Where the Managing agents of a compnay or secretaries and treasurers resign, the Board of Directors shall prepare a statement of affairs from the begining of the year till the date specified. Such a Profit and Loss A/c and Balance Sheet have to be certified b the Companies Auditor [sec 342]

16. 3.3 Other Duties

The Companies Act comtemplates the circumstances which oblige a chartered accountant to report on the statements of accounts, operating results and assets and liabilities of a going company which issues a prospectus. The circumstances are:

(i) when it issues more capital for public subscription;

(ii) if the proceeds of the issue of the shares or debentures are to applied directly or indirectly,

a. in the purchase of a business, or

b. in the purchase of an interest in any business which would make it a holder of more than 50% interest, and

c. if the proceeds of the issue of shares or debentures are to be applied for purchasing shares in a company, making the investing company the majority shareholder.

The report in reference to first case is to be made by the auditor of the company and in remaining cases by any chartered accountant.

1. Duty Regarding Public Deposits by the Company : The auditor of a non-banking company is obliged to enquire under Sec.58(A) and rules made under the directives of the Reserve Bank of india Act, whether the company has furnished the necessary statement regarding public deposits.

2. Duty to produce Documents and Evidence : In terms of Sec.240, a company auditor is under a duty to preserve and produce to an inspector or any other person authorised by him in this behalf with the previous approval of the central government, all books and papers of, or relating, to, the other body corporate which are in their custody or power and otherwise to give to the person all assistance in connection with the investigation which they are reasonably able to give.

3. Report on Accounts on Voluntary Winding up : Under Sec.488(1) where it is proposed to wind up a company voluntarily, the directors of the company have to make a declaration of solvency which includes:

(a) a profit and loss account for the period beginning from the end of the last financial year and ending with a practicable date before the making of the declaration;

(b) a Balance Sheet as on the last mentioned date; and

(c) a statement of the company's assets and liabilities.

The auditor of the company is required to make a report on such balance Sheeet and profit and Loss Account.

4. Duty to Comply with the Directives of the Central Government and that of the Institute of Chartered Accountant of India: This relates to the power of the government to amplify the scope of audit, Sec.227(4)(a). In case the company auditor does not comply with directions given by such bodies, he shall be guilty of professional misconduct.

No limitations can be placed upon the statutory duties of the auditor either by the articles on the other hand the duties of the auditor can be extended by the articles. Therefore the auditor must make himself acquiated with his duties under the Articles and under the Act.

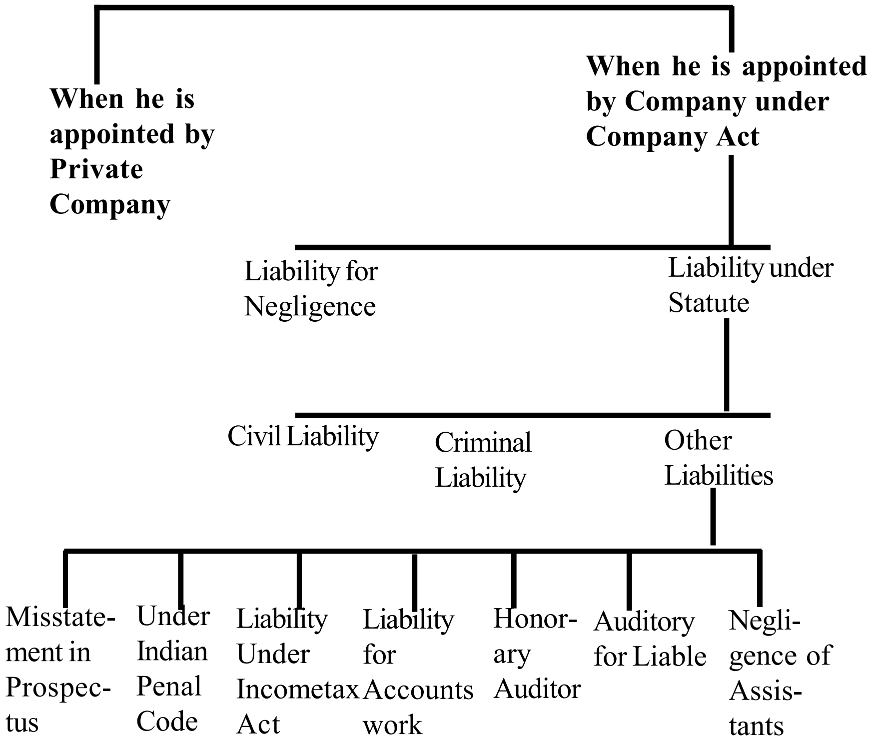
16.4 LIABILITIES OF AN AUDITOR

The Liabilities of an auditor from the legal view point may be discussed under :

a. when he is apointed by a private concern.

b. when he is appointed by a Joint Statutory Company under the companies Act A56.

Liabilities of An Auditor



Liability of an auditor when he is appointed by a private concern:

It is not obligatory for a private concern to appoint an auditor. But if he is appointed by a private concern his duties and liabilities are not defined by any Act. His duties powers and responsibilities depend upon the agreement which is entered into between him and his client. In other words his liability is contractual ability. So the auditor should get definite instructions in writing from his client. If according to instructions the auditor does not examine any books of accounts which he was not required to examine and consequently his client suffers any loss the auditor is not liable. he can be sued only under the contract Act in failing to perform his duties as liad down in the agreement. Even if no agreement was entered into be must show as much skill as is expected of such a person otehrwise he will be responsible nor the damage is constitute such a liability are

a. He must be negligent

b. as a result of negligence a loss is caused

c. the loss is suffered by the person who employed him.

He is expected to show more skill and deligence than a few decades back. Hence some of the decisions given in the past do not hold good now. Example: In the Kingsten Cotton Mills case the auditor could defend himself against the charge of negligence, if he depended upon the certiicate regarding the value and quantity of stock given by the trusted officials of the company but such is not the case today.

The Liability of an auditor under the Company Act

In case of an auditor of a limited company the Company's Act defines his duties and liabilities etc. The liability of an auditor under this head may arise form

1) Liability for negligence under the law of agency.

2) Liability under the statute

a) The Company Act 1956 either civil or criminal

b) Indian Penal Code.

Liability for negligence under the law of agency :The auditor may be sued in a civil court for damage arising out of negligence in the peformance of his dueties. For instance when dividend has been paid out of capital. An auditor is appointed to detect frauds errors etc. If an account of negligence he has failed to do so an consiquently the company suffers a loss, the auditor is held responsible for damage. In the case of agent who does not show as much skill is the performance of his duty as a result of his negligence the principal sufers a loss the agent must compensate his principle under the law of agency. Similarly if an auditor fails to show as much skill, he must sufer the consequence as was decided in the case of Hudson Vs Official Liquidator, Dehra Dun Mussorie Electric Tranway Company. Again in the case of commissioner of Income Tax Vs G.M.Dewdekar, The Auditor was held liable for negligence in not verifying the cash in hand. In other case when the auditor did not submit the audit report in time to enable the client to fulfil the statutory requirement (Lakshmi Narain Sazena).

The Auditor is not liable even though the Company has suffered a loss, if it can be proved that he was not negligence in the performance of his duties. So the other hand even it is proved that the auditor was negligente in the peformance of his duty he can not be held liable for damages of the Company has not suffered any loss due to his negligence as was held in the case of Liver Pool, and Wigan Supply Association Ltd., 1907. In such a case he can not recover the fee payable to him and the ground that he was negligent.

Therefore in order to hold the auditor liable for negligence it must be proved.

a) that he was negligent

b) as a result of his negligence the clieat suffered a loss and

c) that the loss was suffered by the person to whom the auditor owed a duty.

16. 4.1 Civil Liabilities under the Companies Act

The Companies Act puts both civil and criminal liabilities of an auditor. In a number of situations, the auditor may be liable for negligence or misstatements. For Instance:

1. Under Sec.2(30), the term ‘officer’ includes an auditor for the purposes of Secs. 437, 438, 539, 543, 545, 621, 625 and 633, implying thereto that an auditor will be liable under these sections as an officer of the company.

2. Section 62 makes an auditor liable for misstatements in the Prospectus.

3. Section 233 makes an auditor liable to penalties for non-compliance with certain provisions concerning the audit of company’s accounts, i.e. non-compliance with Secs 227 and 229.

4. A Court of law has powers to prosecute an auditor under Secs477 and 478.

5. Section 539 makes an auditor subject to a criminal liability whenever fraudulent flasification of books is carried out by the officers of the company including the auditors.

6. Under Section 628 an auditor is liable for penalty for false statements.

7. Section 545 permits prosecution of delinquent officers, the auditors and the members of the company in the court of winding up.

8. Section 621 lays downs that except the offences under Sec.545, an offence under the Companies Act will be cognisable only on a complaint in writing by the Registrar of Companies, a shareholder of the company, or a person authorised by the central government.

Liability for Misfeasance

Misfeasance means breach of duty. The Company Act impases certain duties on the auditor of the companies. If an auditor commits a bread of such a duty, he is guilty of misfeasance and is therefore liable to pay damages if his client has suffered any loss on account of his negligence. An auditor of a Company is not only liable for misfeasance when he is acting as the auditor of the Company but he is also liable in certain cases when he is no more that auditor of the Company or even when the Company is under liquidation.

In case the Company has gone into liquidation it is the liquidator who can proceed against the past or the present auditor for having committed a breach of duty otherwise the Company can proceed against him.

16.4.2 Criminal Liabilities of An Auditor

Criminal Liability of an auditor arises out of an act constituting a crime when an auditor wilfully makes any voucher or document [sec 628 & sec 538]. Under [sec 533] the court has powers to relieve an auditor to a case against him in proceding for negligence or breach of trust.

Criminal liabilities of an auditor arise because of offences against the statutory provisions. It may arise because of some criminal acts on his part of gross neglect of some provisions of the Companies Act. In all such cases, the auditor is liable not only to the shareholders but to the State as well. Criminal liabilities may emerge becuase of criminal neglect, actual fraud or conspiracy of the auditor. When charged with a criminal liability, an auditor is punishable with fine or imprisonment or both. A company auditir may be guilty of criminal offence under the following sections of the Companies Act.

1. In terms of Sec.63, an auditor is criminally liable for any untrue statement in the prospectus. He shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to Rs.5,000 or with both

2. In terms of Sec.233, if the audit report does not give the required information as under Sec.227 or if it is not signed as in accordance with Sec.229, the auditor or any other signatory is punishable with fine up to Rs.1,000, if the default is wilful.

3. If the auditor does not give the required assistance to an inspector appointed by the central government, the auditor is punishable with imprisonment up to six months or with fine up to Rs.2,000 or with both (sec.240).

4. If on the rpeort of an inspector, the central government prosecutes any person connected with the company, the auditor should asist in the prosecution, otherwise punishable as if he were guilty of contempt of court (Sec.242).

5. When a company is wound up by the court, the auditor is supposed to be present and subject himself to a private examination by the court and is also liable to return to the court any books or documents concerning the company in his possession. If he does not comply accordingly, he can be arrested (Sec.477).

6. The auditor of a company in liquidation can be publicly examined in the High Court if so applied by the Official Liquidator. The notes so signed by the auditor in the court may be used in evidence against him in proceeding - civil or criminal. (Sec.478)

7. An auditor can be held criminally liable, if with the intent to defraud or decieve any persons, he (a) destroys, multilates, alters, etc. any books, papers or securities, or (b) makes or is privy to the making of any false or fraudulent entries in any register or books of account or document belonging to the company. And if convicted, he can be imprisoned for a term which may extend to seven years besides being also liable to a fine (Sec.539).

8. The court may direct the liquidator of a company which is wound up by or under supervision of the court to prosecute the auditor, if he has been found guilty of any criminal offence (Sec.545)

9. An auditor is liable for crimianl prosecution, if he in any return, certificate, Balance Sheet, prospectus, statement or other document required by or of the purpose of the Act, makes a statement (a) which is false in any particular material knowing it to be false.

16.4.3 Other Liabilities

1. Liability for Misstatements in Prospectus

Under Sec.62, an auditor will be liable to pay compensation to every person who subscribes for any shares or debentures on the faith fo the prospectus for any loss or damage sustained becuse of an untrue statement made by him as an expert.

2. Liabilities under the Indian Penal Code

section 197 of the Indian Penal Code provides that whoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, shall be punisable in the same manner as if he gave false evidence. Section 177 of the Indian Penal Code prescribes simple imprisonment up to six months and / or fine up to Rs.1,000 for furnishing false information.

3. Liability under Income Tax Act

Income Ta Act prescribes rigorous imprisonment for a person who abets or induces, in any manner, another person to make and deliver to the income-tax authorities false account, statement or declaration relating to any income chargeable to tax which he knows to be false.

4. Liability for Accounts Work or Unaudited Statements

An auditor is sometimes engaged to carryout accounts work without any audit work. Such engagement have considerable risks for the auditor in as much his name may be usually deemed to indicate that the financial statements or accounts so prepared have been audited whereas in fact they have not been audited at all. A layman may not follow the full implications of the phrase 'unaudited' and may be influenced by the association of the auditor's name with the accounts. In view of diversified practices used by auditors, the contractual obligations of the accountant with his client remain undefined.

5. Liability of an Honorary Auditor

An honorary auditor has no defence under absence of consideration whenever he is charged to be responsible for negligence or misfeasance. An audit work whether paid or unpaid remains an audit. An auditor cannot be given the licence to escape hsi liability on the grounds that the contract is void in view of his not charging anything from the client for his audit work.

6. Liability of Auditors for Libel

An auditor can make a bonafide libelious or slanderous statement. However, if the auditor, while making such a slanderous statement, has actually crossed the scope of his duties, he would be liable even for a bona fide libelious statement.

7. Liability for Negligence of Assistants

The law prohibits an auditor to escape his liability on the gorunds that the said act of negligence or misfeasance was done by his assistants and not by himself. An auditor cannot shift the responsibility on to his assistants. he would personally be liable for any dereliction of duty or absence of care and skill in the performance of an audit.

8. Liability of an auditor to third parties

The question arises whether an auditor can be held liable for damages to third parties if they suffered any loss by relying upon any Balance or any statement signed by him. it is argued that as there is no privity of contract between the auditor and the third party the auditor owes no duty to such a third part and hence he can not be held liable. he is never appointed by the third party and therefore he has nothing to do with such a party as was decided in the case of Le Lievre and Dennes Vs Gould 1893. This question came before a united states court in the case of Ultra mares Corporation Vs. Touche Niven & Company in 1931. In this case a banxer advanced loans to a company on the strength of the Balance Sheet of the Company which had been signed by the auditor. The lender last the money as the Balance Sheet was misleading and fradulent. Therefore the lender sued the auditor for damages.

The plaintiff must prove all the points discussed under the Dery Vs. Peex case Viz:

1. that the statement was untrue in fact

2. that the person making it knew that it was untrue

3. that the statement was made with intent

4. that the plaintiff should act upon it

5. that the plaintiff did act in reliance in it and suffered damages.

In the case of Commissioner of Income Tax Vs. G.M.Dandekar it was held by Ayyar J. that the auditor does not owe any duty to the third party. But it may be stated here that since the decision in Hedley Byrene Company Ltd. Vs. Heller and Partners Ltd. in 1963 the auditor decisions in previous cases that the auditor does not owe any duty to third parties do not hold good now. In the other hand if a misleading statement had been made in a prospectus is sued by a Company and if the auditor had authorised the issue of such a prospectus, he can be held liable for damages to the third party which had purchased the shares of the Company on the basis of such a misleading statement even though they might not have been privity of contract between the two [sec 63].

16.5 SUMMARY

Thus an audtor undetakes a job which is responsible as well as accountable not only to his client but to others as well. An auditors rights are statutory ones and connot be avoided or curtailed in any way by any resolution or even under a provision in the Articles of Association. The duties of an auditor are necessary to submit report which is end result of the Audit Programme. On the other hand he can be held liable and called upon to pay the damages it they prove fraud and wilful or misconduct on the part of the auditor.

16.6 GLOSSARY

Misfeasance	Breach of duty
Expert	Includes amongst others an accountant and any other person whose profession gives authority to a statement made by him.

16.7 SELF ASSESSMENT QUESTIONS

Five Marks Questions

1. What are the rights of an auditor.
2. What are the liabilities of an auditor under Income Tax Act 1961
3. What are the liabilities of an auditor under Chartered Accountants Act 1949

Ten Marks Questions

1. Explain rights and duties of an auditor.
2. Describe Civil Liabilities of an auditor.

Twenty Marks Questions

1. Describe briefly Auditors rights, duties and liabilities.
2. Explain different types of liabilities of an auditor.

16.8 BOOKS RECOMMENDED

1. Practical Auditing	Tandon
2. Auditing - Principles, Practices and Problems	Jagadish Prakash
3. Auditing Theory and Practice	Paradeep Kumar
4. Principles of Auditing	R.G.Saxeena

- Dr. K. Kanaka Durga

Lesson - 17

AUDIT REPORT

17.0 OBJECTIVES

After studying this lesson you should be able to understand.

→ What is an Audit Report

→ How to prepare Audit Report

→ What are the types of Audit

→ What are the features of good Audit Report

Structure

17.1 INTRODUCTION

"A Report is nothing but a statement of facts", An Auditor's Report is the formal result of all the effort that goes into an audit. Communicating the auditors findings to interested users is part of all audits. Thus, the final phase of an audit involves preparing that communication, which is known as the auditor's report. It presents the results of the examination done by the auditor. An audit involves collection of evidence about the financial statements. The conclusions drawn are communicated to the interested parties through the auditor's report.

According to J.C.Roy. "The Report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons there for should be stated. In all cases, where Auditor's name is associated with financial statements the report should contain a clear cut indication of the character of the auditor's examination if any, and the degree of responsibility he is taking".

According to 'Lancaster' Audit Report is "a statement of collected and considered facts, so drawn up as to give clear and concise information of persons who are not already in possession of the full facts of the subject matter of the report."

The information set forth in it should be written in clear and concise words. There should be no room for any ambiguity. Further, the facts and informations which have been incorporated therein are to be conveyed to those persons who do not possess full facts.

Importance of Auditor's Report

The language and words used in audit report are of great importance. The importance of the auditor's report can also be gauged from the following points.

1. Auditor's report is essential for the shareholders of a Company as they do not possess full facts about it.

2. It is the management who are in possession of full facts abou the company's affairs and they may present a wrong picture in their own interest.

3. An independent opinion about the financial affairs of the Company is essential to the Government to impose tax.

17.2 OBJECTIVES OF AUDIT REPORT

A report is a statment of collected and considered facts, drawn up so as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the report. In this context the preparation of report should have the following objectives.

a. To disclose facts without any inference or interpretation.

b. To give complete and informative disclosures as required under law to the management.

c. To give clean opinion in his report.

d.. To give suggestions to the management in managing accounts according to Company Act, 1956.

17.3 CONTENTS OF THE REPORT

Under section 227(2) every auditor is required to make report to the shareholders on the accounts examined by him and every balance sheet and profit and loss account and on every document declared by law to be part of or annexed to the balance sheet and profit and loss account which are placed before the shareholders of the Company at the general meeting during the tenure of his office. An Auditor should state in his report whether -

1. i. In his opinion and to the best of his information, the accounts give the information required by the Act.

   ii. The Balance sheet and the profit and loss account give a true and fair view of the state of Company's affairs as at the end of its financial year.

   iii. He has obtained all the information and explanations were necessary for the purpose of his audit.

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

v. 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. The auditor's report shall also include a statement on such matters as specified by the Central Government under clause 4A of Section 227 of the Companies Act, 1965. According to this section the auditor's report shall also include a statement on specified matters.

3. The auditor's report shall not state that those account have not been properly drawn up on the ground merely that the company has not disclosed certain matters if -

i. those matters are such as the Company is not required to disclose by virtue of any provisions contained in this or any other Act, and

ii. those provisions are specified in the Balance sheet and profit and loss account of the Company.

4. He should see that the profit and loss account is annexed to the Balance sheet and the auditor's report.

17.4 TYPES OF AUDIT REPORT

The auditor's report should contain a clear and written expression of opinion on the financial information. In order to express such an opinion, the auditor should review and assess the conclusions drawn from the audit evidence obtained by him. An opinion may be clean or unqualified, adverse or qualified, or oen not being able to formulate an opinion. The report may be short or long. it may be in the form of a letter or a mere statement. Usually Audit report is prepared in two types. They are -

1. Clean Report

2. Qualified Report

17.4.1 Clean Report

The auditor gives a clean report when he is completely satisfied that there is nothing objectionable in the books of accounts and the Balance Sheet and the profit and loss accounts exhibit the true and fair view of the state of the financial affairs and earnings of the concern. In India, most of the audit reports submitted by the auditors, are clean or qualified. They simply give statutory affirmations without any objection or reservation. Such practice is probably due to the fact that management agree to make the modification in the accounts as desired by the auditors are clean or qualified. They simply give statutory affirmations without any objection or reservation. Such practice is probably due to the fact that management agree to make the modification in the accounts as dessired by the auditors before the report is submitted. The report may be given in the form given below :

Specimen of Clean Report (or Unqualified Report)

To

The Shareholders

MNO Ltd., GUNTUR.

We have audited the attached Balance Sheet of MNO Ltd. as at ..... and the statement of profit & loss account of the company for the years ended on that date, and the schedules annexed thereto and the report as follows :

We report that -

a) we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of the audit.

b) In our opinion, proper books of accounts as required by law have been kept in accordance with the standard accounting practices.

c) The Balance Sheet and Profit & Loss dealt with in the report are in agreement with the books of accounts.

d) 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, 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 company as at .....; and

ii)in the case of Profit and Loss Account of the Company for the year ended on that date.

Date :

Guntur.

For A ,B & Co.
Chartered Accountants
Partner

17.4.2 Qualified Report

If the auditor is of the opinion that the Balance Sheet does not given a true and fair view of the state of the company's affiars or that the profit and loss account does not given a true and fair view of the profit or loss for the year, he must qualify his report accordingly. This report is known as qualified report. when an auditor is to qualify his report, he must decide -

a. to which specific matters their reseravations apply :

b. whether he actively disagrees, or on the other hand lacked sufficient evidence to enable him to form an opinion, as regards material items on the accounts.

c. Whether, in either event, the matters in question are so material as to affect the presentation of a true and fair view.

Specimen of Qualified Report

To

The Shareholders,

ABC Ltd.

We have audited the annexed Balance Sheet of the ABC Ltd. as at ..... and also the Profit and Loss Account for the year ended on that date. We report that

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 accounts as requires by law have been kept by the company, in accordance with the accounting standards, so far as it appears from our examination of the books subject to the comments given hereunder -

i) In the absence of Stock Registers, adjustments relating to balances on the register have been accepted on the basis of the decisions of the management.

c) The Balance Sheet and Profit and Loss Account dealt with by the report are in agreemnt with the books of accounts and returns.

d) Subject to the qualification given below, in our opinion and to the best of information and according to the explanation given to us, the accounts together with the notes thereon and documents attached there to give the information required by the law and accounting standards and gives a true and fair view:

1. In the case of the Balance Sheet of the state of affairs of the company as at ____ and

2. In the case of the Profit and Loss Account of the profit for th year ended on that date.

(i) the provision for depreciation of fixed assets is inadequate.

Dated : For M.N. & Co.

Guntur. Chartered Accountants

17.5 FEATURES OF A GOOD AUDIT REPORT

1. A good Audit Report shall state -

a. Whether the financial statements are prepared and presented in accordance with generally accepted principles of accounting.

b. Whether such principles have been consistently followed.

c. Whether all the informative disclosures have been adequately covered.

2. An Audit Report shall contain an expression of an opinion regarding the financial statements. If an opinion cannot be expressed, the reasons thereof must be stated.

3. It shall preferably state an indication of the extent and character of the Auditor's examination.

4. It shall disclose all material facts known to the auditor which are not disclosed in the financial statements.

5. It shall also disclose all material misstatements known to him to have appeared in the financial statements.

6. It shall clearly identify the financial statements which are under his report.

7. The report shall be addressed to the shareholders who authorise the auditor to examine and audit the accounts.

8. The date of the report shall be the actual date of completion of audit.

9. The auditor generally signs the report in the name he is registered as a practitioner.

17.6 SUMMARY

Each audit starts with an auditor and ends with his report. It is a medium through which the 'audit' function is discharged. A report is a summary of the conclusions as derived from collected and considered data in the opinion of the auditor. It is a statement of facts and a medium of communication. It communicates financial facts. The auditor's report assumes different types according to the opinion formed by the auditor.

17.7 GLOSSARY

Audit Report : Statement of financial facts

17.8 SELF ASSESSMENT QUESTION

Five Marks Questions

1. What is meant by Audit Report.

2. What is the Importance of Audit Report.

Ten Marks Questions

1. What are the contents of Audit Report.

2. What are the features of Good Audit Report.

3. What are the Types of Audit Report.

Twenty Marks Questions

1. What is meant by an Audit Report? What are the general standards of audit reporting.

2. What is a qualified report? Draft a model audit report according to Companies Act, 1956?

17.9 BOOKS RECOMMENDED

1. Text Book of Auditing - V.K.Batra & K.C.Bagardia

2. Auditing Theory & Practice - Pradeep Kumar, Baldev Sachdeva & Jagwant Singh

3. Auditing Principles, Practices and Problems - Jagdish Prakash

- Dr. K. Kanaka Durga

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MODEL QUESTION PAPER

M.Com (Accountancy)
AUDITING

Max. Marks: 70 **Time: 3 hrs.**

SECTION A (Total: 5x3=15 Marks)
(Answer the following questions. Each answer carries 3 marks)

1. a) Objectives of Audit (OR) b) Qualities of an Auditor
2. a) ASBI (OR) b) Guidance Notes
3. a) Audit Planning (OR) b) Audit Note Book
4. a) Stages of Investigation (OR) b) Audit Evidence
5. a) Audit Certificate (OR) b) Audit Report

SECTION B (Total: 5x8 = 40 Marks)
(Answer the following questions. Each answer carries 8 marks)

1. a) Explain ethical Principles of Auditing (or)
b) Discuss briefly Accounting and Auditing
2. a) Explain Auditing and Assurance Standards in India. (or)
b) What is the role of Auditing and Assurance Standards Board of India ?
3. a) What is Audit Planning ,? Discuss about how to prepare Auditing working Papers (or)
b) Discuss about Delegation and Supervision of Audit work.
4. a) Explain about the guiding Principles and Stages of Investigation (or)
b) Briefly explain about documentation of representation by Management
5. a) Expand about contents of Audit report (or)
b) Explain regarding requisites of good audit Reports.

SECTION C (Total: 1x15 =15 Marks)

6. a) Explain about Types of Audit Report (or)
b) What is the importance of auditing ?