AUDITING

For B.Com

SSBN DEGREEE COLLEGE

INTRODUCTION TO AUDITING

The practice of auditing existed even in the Vedic period. Historical records show that Egyptians, Greeks and Roman used to get this public account scrutinized by and independent official. Kautaly in his book "arthshastra" has stated that "all undertakings depend on finance, hence foremost attention should be paid to the treasury".
Auditing as it exists today can be associated with the emerging a joint stock company during the industrial revolution. The company's act of 1956 gives regulations regarding the audit work.

Meaning of Audit:

The word audit is derived from the Latin word **"AUDIRE"** which means to hear. Initially auditor was a person appointed by the owners to check account whenever the suspected fraud, he was to hear explanation given by the person responsible for financial transactions. Emergence of joint stock companies changed the approach of auditing as ownership was pestered from management. The emphasis now is clearly on the verification of accounting date with a view on the reliability of accounting statement.

Definition:

Spicer and **Peglar** define auditing as "An examination of the books, accounts and vouchers of a business's shall enable the auditor to satisfy himself whether or not the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of affairs of the business according to his best of the information given to him and as shown by the book.

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

The international auditing practices committee defines auditing as "the independent examination of financial information of any entity whether profit oriented or not and irrespective of size/legal form when such an examination is conducted with a view to express an opinion thereon".

Scope of Audit.

The scope of audit is increasing with the increase in the complexities of the busines. It is said that long range objectives of an audit should be to serve as a guide to the management future decisions.
Today most of the economic activities are largely conducted through public finance. The auditor has to see whether these larger funds are properly used. The scope of audit encompasses verification of accounts with a intention of giving opinion on its reliability. Hence it covers cost audit, management audit, social audit etc. It should be remembered that an auditor just expressed his opinion on the authenticity of the account. He has no power to take action against anybody, in this regard its said that "an auditor is a watch dog but not a blood hound".

BOOKKEEPING

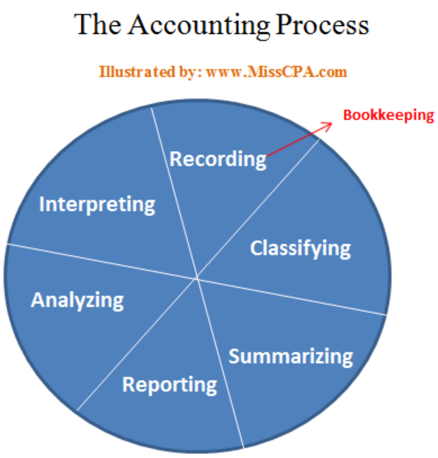
Bookkeeping involves the process of recording, analysing and interpreting the financial transactions of a business or individual. The discipline of bookkeeping accounts for a large proportion of the accounting process. It is a legislative requirement to have up to date financial records to ensure a business pays all necessary taxes and levies. A bookkeeper's duty is to set up financial statements so that an accountant can easily perform legal and tax management in a timely manner.
A skilled and compliant bookkeeper should be able to produce financial records that give business accurate information about its financial activities. These records are critical to the future success of any business.
A good contract bookkeeper is able to:

- Set up accounting systems and software properly
- Enter transactions
- Perform checks, reconciliations and end of year processes
- Ensure they are up to speed with legislative requirements and management reports
- Undertake payroll duties and compliance
- Prepare BAS returns, as a registered BAS agent or under the supervision of a registered BAS agent
- Provide general business administrative support

Definitions

Accounting:

"The art of recording , classifying and summarizing , in a significant manner and in terms of money , transaction and events which are, in part at least, of financial character, and interpreting the result thereof."



Book keeping:

In business transactions are numerous hence it is not possible to remember all the transaction took place in an financial year. Therefore businessmen keep certain books for recording this transaction which is known as book-keeping.

Accounting Vs Book-keeping:

	Accounting	**Book-keeping**
Definition	Preparation of accounting records.	Recording daily activities of revenue and expenditure.
Purpose	Measuring, preparation, analyzing, and interpretation of financial statements. To collect and present financial information.	Keeping an account of all receipts, revenues, expenditure in order to create accounting ledgers.
Goal	To see how the company is performing, to monitor day to day accounting operations, and for taxing.	To see how the company is performing daily and where the money is being earned from and utilized.
Tools	Balance sheets, profit and loss ledgers, positional declarations, and cash flow statements.	Supplier ledger, customer ledger and general ledger and cash book.
Determination of funds	Revenue is acknowledged at the point of sale and not when it was collected. Expenses are acknowledged when they are incurred than when they are paid.	Revenue is acknowledge when it received by a customer on sale of a product or service. Expenses are recorded the moment they occur, including all receipts.

Accounting Vs Auditing.

Accounting	**Auditing**
1. It's a continuous process carried out throughout the year.	1. It's a onetime activity after the closure of accounting year.
2. No prescribed qualification is required to be an accountant.	2. He must be the member of Institute of Chartered Accountants of India to become an auditor.
3. An accountant is a employee of the company.	3. An auditor is an independent professional.
4. An accountant gets regular salary for his work.	4. He gets remuneration for his professional work. Audit fees.
5. Accounting is concerned with recording of business transactions systematically. 6. Accounting precedes, auditing.	5. Its concerned with verification of accounts prepared by the accountant. 6. Auditing succeeds accounting.

Usually an auditor confines his work only to the verification of accounts. In small organizations he may also be asked to finalize accounts. In this case he acts both as an accountant and as an auditor but the audit work commences only when the accounting work is over. Hence, it's said that "Audit begins where accounting ends".

Audit Vs Investigation:

	Audit	**Investigation**
Description	Audit means the inspection, examination or verification of a person, organization, system, process, enterprise, project or product.	Investigation means an inquiry, or is the act of detail examination of activities so as to achieve certain objectives.
Owners	Audit is conducted on behalf of owners only and they make the appointment.	Investigation may be conducted either by owner of the undertaking or by an outsider.
Purpose	To determine the true and fair view.	Varies from business to business
Process	Routine process	Investigation is not a regular process
Scope	It includes only an examination of the accounts of a business	It covers an examination of the accounts bur also covers an inquiry into other matter that are connected with the purpose for which it is undertaken
Period	Year or six months	May cover several years
Employees	Does not examine personally	May examine personally
Sequence	Usually conducted before investigation of accounts	Usually conducted after the audit of accounts
Person performing work	Audit is to be conducted by a chartered accountant	Investigation may be take on even by a non-chartered accountant
Legal Obligations	Audit is mandatory under law	There is no such legal obligations with regard to investigation

Audit Process and Procedure

The audit process is generally a ten-step procedure as outlined below. Please click through the steps in order to better understand the process.

1. **Notification**
2. **Planning**
3. **Opening Meeting**
4. **Fieldwork**
5. **Communication**.
6. **Report Drafting**
7. **Management Response**
8. **Closing Meeting**
9. **Report Distribution**
10. **Follow-up**

Notification

First, you will receive a letter to inform you of an upcoming audit. The auditor will send you a preliminary checklist. This is a list of documents (e.g. organization charts, financial statements) that will help the auditor learn about your unit before planning the audit.

Planning

After reviewing the information, the auditor will plan the review, conduct an engagement risk assessment, draft an audit plan, and schedule an opening meeting.

Opening Meeting

The opening meeting should include senior management and any administrative staff that may be involved in the audit. During this meeting, the scope of the audit will be discussed. You should feel free to ask the auditors to review areas that you are concerned about. The time frame of the audit will be determined, and you should discuss any potential timing issues (e.g. vacations, deadlines) that could impact the audit. It doesn't take as much of your time as you might expect!

Fieldwork

After the opening meeting, the auditor will finalize the audit plan and begin fieldwork. Fieldwork typically consists of talking with staff, reviewing procedure manuals, learning about your business processes, testing for compliance with applicable university policies and procedures and laws and regulations, and assessing the adequacy of internal controls. You should make your staff aware that the auditor will be scheduling meetings with them.

Communication

Throughout the process, the auditor will keep you informed, and you will have an opportunity to discuss issues noted and the possible solutions.

Report Drafting

After the fieldwork is completed, the auditor will draft a report. The report consists of several sections and includes: the distribution list, the follow-up date, a general overview of your unit, the scope of the audit, any major audit concerns, the overall conclusion, and detailed commentary describing the findings and recommended solutions. You should read the draft report carefully to make sure there are no errors. If you find a mistake, inform the auditor right away so that it can be corrected before the final report is issued.

Management Response

Once the report is finalized, we will request your management responses. The response consists of 3 components: whether you agree or disagree with the problem, your action plan to correct the problem, and the expected completion date.

Closing Meeting

A closing meeting will be held so that everyone can discuss the audit report and review your management responses. This is an opportunity to discuss how the audit went and any remaining issues.

Report Distribution

The report is then distributed to you, your manager(s), senior university administrators, internal audit, and the university's external auditors. We also distribute an audit survey to the audited unit to solicit feedback about the audit. Feedback is important to us, since it can help us improve the audit process.

Follow-Up

Follow-up reviews are performed on an issue-by-issue basis and typically occur shortly after the expected completion date, so that agreed-upon corrective actions can be implemented. The purpose of the follow-up is to verify that you have implemented the agreed-upon corrective actions. The auditor will interview staff, perform tests, or review new procedures to perform the verification. You will then receive a letter from the auditor indicating whether you have satisfactorily corrected all problems or whether further actions are necessary.

Objectives of Auditing.

Auditors are basically concerned with verifying whether the account exhibit true and fair view of the business. The objectives of auditing depends upon the purpose of his appointment.

Primary Objective.

The primary objective of an auditor is to respect to the owners of his business expressing his opinion whether account exhibits true and fair view of the state of affairs of the business. It should be remembered that in case of a company, he reports to the shareholders who are the owners of the company and not tot the director. The auditor is also concerned with verifying how far the accounting system is successful in correctly recording transactions. He had to see whether accounts are prepared in accordance with recognized accounting policies and practices and as per statutory requirements.

Secondary Objective:

The following objectives are incidental to the main objective of audting.

1. **Detection and prevention of errors:** errors are mistakes committed unintentionally because of ignorance, carelessness. Errors are of many types:
   a. **Errors of Omission:** These are the errors which arise on account of transaction into being recorded in the books of accounts either wholly partially. If a transaction has been totally omitted it will not affect trial balance and hence it is more difficult to detect. On the other hand if a transaction is partially recorded, the trial balance will not agree and hence it can be easily detected.
   b. **Errors of Commission:** When incorrect entries are made in the books of accounts either wholly, partially such errors are known as errors of commission. Eg: wrong entries, wrong Calculations, postings, carry forwards etc such errors can be located while verifying.
   c. **Compensating Errors:** when two/more mistakes are committed which counter balances each other. Such an error is know an Compensating Error. Eg: if the amount is wrongly debited by Rs 100 less and Wrongly Credited by Rs 100 such a mistake is known as compensating error.
   d. **Error of Principle:** These are the errors committed by not properly following the accounting principles. These arise mainly due to the lack of knowledge of accounting. Eg: Revenue expenditure may be treated as Capital Expenditure.
   e. **Clerical Errors;** A clerical error is one which arises on account of ignorance, carelessness, negligence etc.

   Location of Errors: It is not the duty of the auditor to identify the errors but in the process of verifying accounts, he may discover the errors in the accounts. The auditor should follow the following procedure in this regard.

   1. Check the trial balance.
   2. Compare list of debtors and creditors with the trial balance.
   3. Compare the names of account appearing in the ledger with the names of accounting in the trial balance.
   4. Check the totals and balances of all accounts and see that they have been properly shown in the trial balance.
   5. Check the posting of entries from various books into ledger.
2. **Deduction and Prevention of Fraud:** A fraud is an Error committed intentionally to deceive/ to mislead/ to conceal the truth/ the material fact. Frauds may be of 3 types.
   a. **Misappropriation of Cash:** This is one of the majored frauds in any organisation it normally occurs in the cash department. This kind of fraud is either by showing more payments/ less receipt.

The cashier may show more expenses than what is actually incurred and misuse the extra cash. Eg: showing wages to dummy workers. Cash can also be misappropriated by showing less receipts
Eg: not recording cash sales. Not allowing discounts to customers. The cashier may also misappropriate the cash when it is received. Cash received from 1st customer is misused when the 2nd customer pays it is transferred to the 1st customer's account. When the 3rd customer pays it goes forever. Such a fraud is known as "Teaming and Lading". To prevent such frauds the auditor must check in detail all books and documents, vouchers, invoices etc.

b. **Misappropriation of Goods:** here records may be made for the goods not purchase not issued to production department, goods may be used for personal purpose. Such a fraud can be deducted by checking stock records and physical verification of goods.

c. **Manipulation of Accounts:** this is finalizing accounts with the intention of misleading others. This is also known as "WINDOWS DRESSING". It is very difficult to locate because its usually committed by higher level management such as directors. The objective of WD may be to evade tax, to borrow money from bank, to increase the share price etc.
to conclude it cab be said that, it is not the main objective of the auditor to discover frauds and irregularities. He is not an insurance against frauds and errors. But if he finds anything of a suspicious nature, he should probel it to the full.

Advantages & Limitations of Audit

Advantages of Audit

1. **For the owners of business.**
2. **For the management**
3. **For employees, potential**
4. **or Government**
5. **For Others**

Limitations of Audit

1. **Postmortem of accounts**
2. **Audit may not provide complete picture.**
3. **Qualitative aspects ignored.**
4. **Inadequate external evidence**
5. **Formation of faulty Judgement**

Advantages of Audit

I) For the owners of business :

1. Greater reliability on the financial statements.
2. Improvement in the efficiency with consequential increase in the overall profitability.
3. In case of proprietary concern, audited statement of accounts provide a proof that all business transactions have been duly accounted for and there are no errors or fraud.
4. In case of a partnership Firm it servers as an evidence of proper management o9f the affairs of business. Such accounts are also of great help in settlement of accounts in case of admission, retirement or death of partner.
5. In a joint stock company, the shareholders rely on the audited statements of accounts to satisfy themselves that the affairs of the company are being run in an efficient manner and there is no miss utilization of shareholders fund.
6. In case of co-operative societies, trusts etc. it serves as an evidence that the interest of the beneficiaries and members are being properly looked after.

II) Advantages to the management:

1. Easy dealings with third parties like Banks, creditors, financial institutions and insurance companies, due to credibility of the financial statements which are audited.
2. It ensures compliance with legal requirements.
3. Efficient use of resources through identification of inefficiencies leading to remedial measures.
4. It acts as a moral check on the employees and improves the management control.
5. It creates greater confidence of owners in management.

III) Advantages to employee, investors and creditors:

1. It provides a reliable base for taking investment, credit and other decisions.
2. It safeguards the interest of the employees and workers because audited accounts are useful for settling trade disputes e.g., hike in wages or to get higher bonus.
3. Long term and short term creditors can rely on audited accounts while taking decisions to grant credit to business concerns.

IV) For government:

1. For determination of liability under sales tax, income tax etc., tax authorities can rely upon the audited statements of accounts.
2. Audited statements of accounts can serve the purpose for taking policy decisions like price fixation, grant of subsidies, reduction of tax rates etc.,
3. Audited accounts can be produced in the court to provide an evidence.

V) For others:

1. Audited accounts can be used by insurance companies to settle the claims arising on account of loss by fire.
2. In case of amalgamation and absorption, the purchasing company can calculate purchase consideration on the basis of audited accounts.

Limitations of Auditing:

1. **Postmortem of accounts:**
   Auditing is a post-mortem examination of accounts. Auditing begins where accountancy ends which means auditor is no where around when the accounts are prepared and finalized. Therefore, it may not be possible for him to discover manipulations of fraud in the books of accounts at the preparatory stage.
2. **Auditing may not provide complete picture:**
   Sometimes the auditor has to depend on explanations, clarifications and information from staff and client. Authentiicity of such information is always open to question, if the personnel so prociding it have themselves been a party to the manipulation of books of accounts. As a result, the auditd statements may not reveal the correct or complete picture.
3. **Qualitative aspects ignored:**
   Auditing as a practical subject mainly deals with procedures and techniques of checking, ticking, totaling, Vouching etc., As a result several aspects such as business eiths, managerial efficiency and effectiveness are ignored. In such circumstance, it can hardly be expected to do justice to its objects.
4. **Inadequate external evidence:**

Auditor has to seek opinion of experts on certain matters on which he may not have expert's knowledge. For example, a debtor of the business might provide wrong information about the debt owed by him. The valuer of the assets might go wrong in valuing an asset. In such a case, even audited accounts may lack authenticity.

5. **Formation of faulty judgment :**
   The auditor's judgment in relation to correctness and fairness of the proposition in the books of accounts is based on evaluation and critical review of the evidence collected by hi, through appropriate audit techniques. However, sometimes his personal opinion might could his sense of judgment so that his report might contain an assessment which is not show the correct position of the business.

Qualifications & Disqualifications of Company Auditor

Audits can be classified into two groups namely: Optional Audit and Compulsory Audits. The audit which is not legally required is called optional audit which is otherwise known as private audit. The audit which is legally required is called compulsory audit which is otherwise known as statutory audit.

In case of optional audits rights, duties, liabilities, etc of auditor will be of Contractual nature. That means all those things will be determined by agreement which has got formed between auditor and client. But in case of Compulsory audits rights, duties, etc of auditor will be of Statutory nature, that means concerned act itself determines rights, duties etc of auditor. Audit of Joint Stock Companies comes under Statutory Audits.

Qualifications of Company Auditor

According to Sec. 226 of Companies Act, Company auditor should be either Chartered Accountant or Certified Auditor.

Chartered Accountant: The members of `*Institute of Chartered Accountant of India*` are called Chartered Accountants. Their profession is regulated by Chartered Accountants Act 1949. A firm of Chartered Accountants may also conduct company audit. But every partner of such firm must be a Chartered Accountant.

Certified Auditor: The persons who are the holders of certificates issued by Central Government under Certified Auditors Rules are called Certified Auditors. They can also carry on auditing profession at anywhere in India. They are also eligible to conduct Company Audit.

Disqualifications of Company Auditor

Section 226(3) of Companies Act reads about disqualifications of company auditor. The following persons are disqualified;

- Body corporate
- Officer or employee of the company
- Partner or employee of an office or employee of the company.
- Insolvent person
- Lunatic person
- A person who is indebted to the company for a sum exceeding Rs. 1000/-
- A person who has given guarantee for such sum relating to the company.

- If a person is disqualified to holiday company, automatically he gets disqualified to its subsidiaries also. In the same way if a person is disqualified to subsidiary company, he gets disqualified to related holding company also

Appointment of a Company Auditor

Section 224 of the Act deals with the appointment of a company auditor.

a) **First Auditor: -** According to Section 224 (5) the first auditor is appointed by directors within one month of its registration. The first auditor holds office till the first annual general meeting is held. He may or may not be continued after the annual general meeting (AGM). If he is to be removed at least 14 days notice has to be given to him before the meeting. If the directors do not appoint the first auditor the shareholders may appoint him in their general meeting.

b) **Subsequent Auditor: -** According to Section 224 (1) every subsequent auditor is appointed at the annual general meeting (AGM). He holds office from the AGM in which he is appointed until the next AGM. The auditor has to inform his acceptance or otherwise within 30 days of receiving information to the registrar of companies. If he does not accept the offer the vacancy can be treated as neither as casual vacancy nor as vacancy by resignation. The company has to convene another AGM to appoint a new auditor.

c) **Appointment by Central Government: -** When the AGM fails to appoint an auditor the Central Government may appoint an auditor within 7 days of being informed by the company.

d) **Appointment by Special Resolution:-** In case of companies where more than 25% of capital is held by a nationalized bank, insurance company, government company or state government, etc the auditor of such a company must be appointed by passing a Special Resolution.

e) **Auditors of Government Companies: -** Auditors of all government companies are appointed by the Central Government on the advice of the Controller and Auditor General of India (CAG). In such a case the report is to be submitted to the CAG.

Removal of an Auditor

The first auditor of a company appointed by the directors, may be removed by the shareholders in the AGM by giving at least 14 days notice.

To remove the subsequent auditor, the company has to take prior permission of the Central Government & pass an ordinary resolution. There should be sufficient grounds to remove a subsequent auditor.

An auditor cannot audit more than 20 companies at a time.

Rights of a Company Auditor

According to the companies act the auditor has the following rights:

1) Right to Access Books of Accounts

Every auditor of a company has the right to inspect all books, documents, vouchers, agreements etc. These must be made available to him whenever he requests for them.

2) Right to Obtain Information & Explanation

An auditor is authorized to call for explanation & ask for information from any officer of the company required to perform his professional duties.

3) **Right to Inspect Branch Accounts**

If branch accounts are audited by a different person he has a right to visit the branch office if necessary & inspect its books of accounts. In case of branches of a bank overseas, the auditor may be given the extracts of accounts.

4) **Right to Receive Notice**

The act describes that the auditor has the right to receive all notices & communications which an ordinary member of a company is entitled to receive relating to any general meeting. He also has the right to attend meeting& to make any statement regarding the accounts audited by him. But he has no obligation to answer any questions raised at the meeting.

5) Right to Sign Audit Reports

The audit report can be signed only by such person who has been appointed as an auditor.

If a firm is appointed to audit any partner may sign in the report. The auditor has the right to recommend to the board necessary changes in the accounting system. If the changes are not implemented he has the right to mention the same in his report.

6) Right to Seek Advice

Whenever necessary to perform his professional duties, the auditor has the right to seek experts' opinion on technical & legal matters.

7) Right to be Indemnified

The Companies Act considers the auditor as one of the officers of the company, hence he has the right to be indemnified out of the assets of the company against any liability incurred by him while defending a case whenever a case is file against him & he is not found guilty.

8) Right to Remuneration

The auditor has the right to receive remuneration as prescribed by the law. This right cannot be taken away either by changing the Articles of Association or by Passing a Resolution by Members.

9) Auditor's Lien

It refers to the right of the auditor to withhold certain documents & papers unless certain documents due to him are cleared.

Auditor has no lien on the books of accounts audited by him but if he has worked as accountant also for which he is not paid he can exercise his right of lien.

The auditor has lien over audit working papers as they belong to him regarding the correspondence between the auditor & his clients, he can exercise the right of lien.

Duties of the Auditor

a) Statutory Duties

The auditor has a duty to report to the shareholders of the company on the accounts examined by him. Among other things he should state whether the accounts give necessary information as required by law, whether the accounts exhibit true and fair view of the business and whether books of accounts maintained by the company are accordance with the law.

b) Duties Under Section 227

Under this section the auditor is required to enquire whether loans & advances made by the company are properly secure, whether the transactions recorded in the books are not against the interest of the company.

c) Other Duties under the Companies Act

It is the duty of the auditor to sign the audit report. He has to report certain matters included in the prospectus of the company. He has to report in the statutory report about the allotment of shares. He has to preserve all documents & present them before investigators whenever he is asked to do so.

d) Contractual Duties

These duties arise out of the conditions of appointment accordingly he must be honest & exercise reasonable skills & care. In Kingston Cotton Mills case it was observed that 'It is duty of an auditor to bring to the world that skill, care & caution which is reasonably expected of a competent auditor. He is not bond to be a detective; he need not approach his work with suspicion. ***He is a watch dog but not a blood hound***'

In the case of London General Bank it was observed that the auditor must be honest ie he must not certify what he does not believe to be true & must take reasonable care & skill before he believes what he certifies to be true.

e) Duties regarding Accounting Standards

It is the duty of the auditor to ensure that accounting standards are implemented in the financial statements. If there is any deviation from the accounting standards it is his duty to state in his report such deviations.

f) Professional Duties

As a member of accounting profession it is his duty to observe professional ethics.

Liabilities of a Company Auditor

The company auditor is liable when he fails to detect errors & frauds. The nature of liability depends upon the nature of his work & contract. The Companies Act specifies the liabilities of a company auditor whenever he fails in his duty.

Liability for Negligence

Whenever an auditor is negligent & because of this the client has suffered losses the auditor is liable to compensate his client to the extent of the losses suffered.

If the auditor does not perform his duty without exercising reasonable care & skill the auditor will be held responsible, if it is proved that

a) Auditor was negligent in performing his duty
b) The client has suffered losses due to his negligence

Regarding auditor's liability to third parties – he is liable only when the third party suffers losses because of his negligence. The auditor is not liable when the third party does not suffer losses though it is proved that the auditor was negligent or if the third party suffers losses but not because of the auditor's negligence.

Liabilities under the Company's Act

Civil Liability

The auditor is liable when he holds any documents or papers which may not be in the interest of the company. When a company is wound up & if it is proved that fraud was committed at the time of the promotion of the company.

Liability for Mis – Statement in Prospectus

The auditor is held responsible for giving any false statement in the prospectus. He is liable to compensate every person who has invested money based upon such prospectus however. He is not liable under the following circumstances:

1) He withdraws his concern before the delivery of the prospectus for registration.

2) After registration but before allotment after becoming aware of the untrue statement he withdraws his concern in written & gives public notice of the same.
3) He could not identify & prove that he believed the prospectus in good faith & signed it.

Liability for Misfeasance

Misfeasance is simply breach of trust. An auditor is recognized as one of the officers of the company & because of his breach of trust if the company suffers losses it can recover it from the auditor within 5 years.

In the case of London & General Bank it was observed that, if the auditor gives more information in respect of Company's financial position to the shareholders, can be held guilty of breach of trust.

In the case Kingston Cotton Mills Company Limited the judge observed that the auditor is not liable to take complete stock of the business. He can rely upon the trusted company officials. It is a duty of the auditor to perform his work with reasonable care, caution & competence. He is not bound to be a detective. He can rely upon the trusted officials & assume that they are honest.

He is a watchdog but not a bloodhound.

In the case of City Equitable Fire Insurance Company Limited the judge observed that it is a duty of the auditor to see that securities of the company actually exist & are in safe custody.

Criminal Liability of an Auditor

An auditor being an officer of the company can be held criminally liable if he willfully makes a false statement in any report written, certificate, Balance Sheet, etc.

According to Section 628 an auditor can be fined & imprisoned upto 2 years if he makes a false statement knowing it to be false & deliberately omits any material fact. Under Section 539 if he is found guilty of criminal offense at the time of winding up along with the fine he can be imprisoned upto 7 years. If it is proved that he was a party to mis – statement in the prospectus he can be imprisoned upto 2 years.

Under Section 68 an auditor is liable if he fraudulently induces people to invest money.

Liability under Other Acts

Income Tax Act

If an auditor is held guilty of misconduct while representing his client before the income tax authorities, he can be disqualified from practicing. He can be imprisoned upto 2 years for furnishing false information.

He also faces rigorous imprisonment upto 2 years for helping or inducing another person to give also false account statement declaration etc before the income tax authorities.

Chartered Accountants Act

Under the act the institute can penalize the auditor for any professional misconduct.

Remuneration of Auditors

In accordance with the provisions of Sub-section (8) of Section 224, the remuneration of the auditors of a company—

(a) in the case of an auditor appointed by the Board or the Central Government, may be fixed by the Board or the Central Government, as the case may be; (i) in the case of an auditor appointed under Section 619 by the Comptroller and Auditor General of India, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine; and

(b) Subject to clause (i), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

Engagement Letter

When taking a new client, an auditor creates an engagement letter to solidify audit arrangements between the audit firm and the client. The letter serves as the contract, detailing the duties and obligations on either side of the table. Your CPA firm prepares the engagement letter.

Although you aren't required to have a written agreement with an audit client (per SAS No. 108), it is unwise to undertake an audit with only a verbal agreement.

Who you address the engagement letter to depends on the type of business entity. If you're working with a corporation, address the letter to the board of directors. If your client is a small corporation that doesn't have a board of directors, address the letter to the chief executive officer. If you're auditing a sole proprietorship, address it to the owner. For a partnership entity, address it to the partners.

Here are the topics you should cover in an engagement letter:

- **The objectives of the engagement:** For example, for a financial statement audit, the objective is to express an opinion on the financial statements.
- **Responsibilities of management:** These can vary based on the terms and conditions of the engagement. For example, the financial statements and the proper application of generally accepted accounting principles are the responsibility of management.
- **Responsibilities of the auditor:** These also vary. For a financial statement audit, one responsibility is that you conduct the audit in accordance with GAAS.
- **Limitations of the engagement:** You should address the fact that the audit is meant to provide reasonable assurance regarding whether the financial statements are free of material misstatements. However, because you don't examine all transactions, there's a risk that material errors, fraud, or illegal acts exist and aren't detected.
- **Hiring restriction:** A general engagement letter condition is that the client won't try to hire anyone on the current audit team. Usually there's a required, one-year cooling-off period between working on a client audit and accepting a position with that company.

Other items you should clear up through the engagement letter are your fees and when you expect the company to pay them. If you plan on using specialists in the company's field to assist you, include that fact as well. It's wise to spell out the conditions under which you'll terminate the engagement — for example, if the client's books render you unable to express an opinion.

What not to include in the engagement letter? Don't use jargon that only CPAs understand. Doing so will make your client uncomfortable and may cause the client to refuse to sign the letter. Also, don't overstate what you can do. And certainly don't include any promotional or marketing information.

The engagement letter is signed by your CPA firm — for example, "Smith and Jones." It can also be signed by the firm's contact person, such as "Joe Smith, Partner." The engagement letter also has a place for the client to sign, acknowledging that it accepts the letter's terms.

Types Of Audit Program

Audit program can be classified into following two groups:

1. Fixed Audit Program

Generally, auditor prepares audit program on the suggestions and recommendation of assistant staffs but such program can not be changed during the course of audit which is known as fixed audit program. Such program, due to pace of time or change in the situation and size of the client needs to change even though it can not be changed. Fixed audit Program can be used in all the organizations.

Advantages Of Fixed Audit Program

* Fixed audit programs are prepared once and program is used in all the organization. So, it saves time and cost.
* All the works are completed within the stipulated time because auditor does not change such program on the request of assistant staff.
* Audit program fixes the responsibility of assistant staffs. So, they know their responsibility and complete their work in time which helps to prepare and present report in time.

Disadvantages Of Fixed Audit Program

* Such program is rigid. So, it cannot be used in all organizations because nature and size of all the businesses do not remain same.
* Same program will not be useful in the big and small organizations.
* Fixed audit program is unscientific and impracticable because it does not incorporate the changes caused by time and situation.
* Fixed audit program harasses the staffs because intelligent staffs cannot use their skill and knowledge.

2. Flexible Audit Program

An audit program which can be changed as per the need, time, nature of business and auditing standard is known as flexible audit program. Such program should be reviewed on the recommendations and suggestions of assistants. Such change can be made due to change in number of work, nature of business, change in management and their feelings. It is just taken as helping part but assistants can use their knowledge, caliber and intelligence.

Advantages OF Flexible Audit Program

* Auditing remains effective because it can be changed if the change is made in the nature and size of business.
* Assistant staffs remain happy because such programs are prepared incorporating to the problems of assistant staffs.
* Flexible audit program remains effective because it incorporates to the change made due to time and situation

Audit Note Book

A note book which is prepared by the audit staff to note down all the uncleared queries which s/he may find in the course of audit and requires further clarification and explanation is known as audit note book. Audit note book contains information regarding day-to-day work performed by the audit staff on any particular date. Notes about all types of errors, difficulties and uncleared queries or points to be discussed with the auditor or clients and the points which are to be incorporate in the report are noted down.

Contents Of Audit Note Book

General Information

Generally the following information is incorporated in audit note book:

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 (in the case of limited companies) and Partnership Deed (in the case of partnership firm) and other legal documents.
2. The name of the client and the audit year.
3. A list of books of accounts in use.
4. Names of principal officers, their duties and responsibilities.
5. Particulars of the accounting and financial system followed and the internal check in operation in the business.
6. Details regarding accounting and financial policies followed in the business.
7. A copy of the audit program.

Special Matters To Be Recorded In The Audit Note Book

1. Routine queries not cleared, i.e., missing receipts and vouchers etc.
2. Details of mistakes and errors discovered.
3. The points raised during the course of audit, to which the attention of the auditor must be drawn, i.e. failure of the company to comply with the provisions of the Companies Act or of the Memorandum of Association and other legal requirements.
4. Extracts from minutes books and contracts and other correspondence with various government agencies, financial institutions, debtors, creditors etc.
5. The points to be incorporate in the audit report.
6. The points which needs further explanation and clarification e.g., a change in the basis of valuation of finished stocks or in the computation of depreciation, etc.
7. Date of commencement and completion of the audit.

Functions and Nature of Working Papers

Working papers serve mainly to—

a. Provide the principal support for the auditor's report, including his representation regarding observance of the standards of field work, which is implicit in the reference in his report to generally accepted auditing standards.
b. Aid the auditor in the conduct and supervision of the audit.

Working papers are records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the engagement. Examples of working papers are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor. Working papers also may be in the form of data stored on tapes, films, or other media.

Factors affecting the auditor's judgment about the quantity, type, and content of the working papers for a particular engagement include (a) the nature of the engagement, (b) the nature of the auditor's report, (c) the nature of the financial statements, schedules, or other information on which the auditor is reporting, (d) the nature and condition of the client's records, (e) the assessed level of control risk, and (f) the needs in the particular circumstances for supervision and review of the work.

Content of Working Papers

The quantity, type, and content of working papers vary with the circumstances (see paragraph .04), but they should be sufficient to show that the accounting records agree or reconcile with the financial statements or other information reported on and that the applicable standards of field work have been observed. Working papers ordinarily should include documentation showing that—

a. The work has been adequately planned and supervised, indicating observance of the first standard of field work.
b. A sufficient understanding of internal control has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
c. The audit evidence obtained, the auditing procedures applied, and the testing performed have provided sufficient competent evidential matter to afford a reasonable basis for an opinion, indicating observance of the third standard of field work.

Working papers are the property of the auditor, and some states have statutes that designate the auditor as the owner of the working papers. The auditor's rights of ownership, however, are subject to ethical limitations relating to the confidential relationship with clients.

Certain of the auditor's working papers may sometimes serve as a useful reference source for his client, but the working papers should not be regarded as a part of, or a substitute for, the client's accounting records.

The auditor should adopt reasonable procedures for safe custody of his working papers and should retain them for a period sufficient to meet the needs of his practice and to satisfy any pertinent legal requirements of records retention.

Contents of Audit Report

Auditor should check the books of accounts and balance sheet and need to prepare the audit report addressing to the shareholders and present it to the concerned department and to the company. Copy of such report should be sent to all the shareholders. Audit report should contain the following things.
1. Answer, clarification and explanation of furnished questions are given by the concerned authority satisfactory or not.
2. Income statement and balance sheet is prepared by the company in prescribed structure or not.
3. Accounts are maintained as per the provision of laid down rules and regulations or not.
4. Balance sheet of the company presents true and fair view of financial position or not.
5. High ranking official, representatives and staffs of the company have performed work as per the provision of rules and regulations or not; they have committed fraud or not.
6. Transactions of the company are satisfactory or not.
7. Auditor should provide suggestion if necessary.

In addition to above facts, an auditor should include other facts using his own discretion. Other facts which are to be incorporate in the report are given below:
1. An auditor should include all the facts demanded by the Company Act.

2. Auditor should include the true and fairness of books of accounts as well as facts where he is not able to satisfy himself.
3. Auditor should include all the important facts which directly affect the financial position of the company.
4. Some abnormal transactions which are found during the course of audit but they are necessary for the company should be incorporated in the audit report.
5. If financial statements like income statement and balance sheet are not maintain properly, an auditor should clearly state in the audit report.
6. An auditor should include in the report that the audit of books of account is made in detail or applying test check.
7. If there is special situation, an auditor should include it in the audit report.
8. If auditor detects any frauds and errors during the course of audit, he must include in audit report clearly stating their effect in financial statements. Like regarding valuation of stock, depreciation system demarcation of capital and revenue etc.

Concept and Objectives of Internal Check

Concept of Internal Check

An internal check is a part of internal control. Internal check is the process of arrangement of duties of various staffs of a business in such way that work is automatically checked by the next staff while performing their duties. Frauds which are committed by a staff are automatically detected and corrected by the another staff. So, it helps a lot in the work of final audit. For example, a staff records the expenditure in a book and another staff posts them into ledger, another staff checks and verifies the ledger and payment is made by another staff. So, the work of one staff is checked by the another staff while performing their works so that errors and frauds committed by one staff are detected and prevented by the another staff.

Objectives of Internal Check

Following are the objectives of internal check system:

1. To eliminate the frauds and errors which may be committed by the staffs.
2. To prevent misappropriation of cash or stock.
3. To ensure the reliability of information produced by the accounting system.
4. To detect errors and frauds promptly which helps to minimize their effects in long term.
5. To exercise moral pressure over the staffs.

Internal Control

Definition of Internal Control:

Internal control is the process, effected by an entity's Board of Trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

a. Reliability of financial reporting,
b. Effectiveness and efficiency of operations, and
c. Compliance with applicable laws and regulations.

Types of Internal Controls:

1. **Detective:** Designed to detect errors or irregularities that may have occurred.

2. **Corrective:** Designed to correct errors or irregularities that have been detected.
3. **Preventive:** Designed to keep errors or irregularities from occurring in the first place.

Limitations of Internal Controls:

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:

1. **Judgment:** The effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information at hand.
2. **Breakdowns:** Even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.
3. **Management Override:** High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.
4. **Collusion:** Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

Internal Control Objectives

Internal Control objectives are desired goals or conditions for a specific event cycle which, if achieved, minimize the potential that waste, loss, unauthorized use or misappropriation will occur. They are conditions which we want the system of internal control to satisfy. For a control objective to be effective, compliance with it must be measurable and observable.

Internal Audit evaluates Mercer's system of internal control by accessing the ability of individual process controls to achieve seven pre-defined control objectives. The control objectives include authorization, completeness, accuracy, validity, physical safeguards and security, error handling and segregation of duties.

- **Authorization** - The objective is to ensure that all transactions are approved by responsible personnel in accordance with specific or general authority before the transaction is recorded.
- **Completeness** - The objective is to ensure that no valid transactions have been omitted from the accounting records.
- **Accuracy** - The objective is to ensure that all valid transactions are accurate, consistent with the originating transaction data and information is recorded in a timely manner.
- **Validity** - The objective is to ensure that all recorded transactions fairly represent the economic events that actually occurred, are lawful in nature, and have been executed in accordance with management's general authorization.
- **Physical Safeguards & Security** - The objective is to ensure that access to physical assets and information systems are controlled and properly restricted to authorized personnel.
- **Error handling** - The objective is to ensure that errors detected at any stage of processing receive prompt corrective action and are reported to the appropriate level of management.
- **Segregation of Duties** - The objective is to ensure that duties are assigned to individuals in a manner that ensures that no one individual can control both the recording function and the procedures relative to processing the transaction.

A well designed process with appropriate internal controls should meet most, if not all of these control objectives.

Advantages Of Internal Control

Application of internal control provides the following benefits to the various parties:

1. Internal control helps to protect the assets of the business from misuse, theft, accident etc.
2. Internal control helps to implement management policies to attain corporate goals.
3. Internal control helps the auditor in his/her work detecting all the errors and frauds which are committed in the books of accounts.
4. Internal control helps to increase the accuracy and reliability of financial statement and books of accounts.
5. Internal control helps to regulate the work of staffs through division of work among the staffs in a scientific manner which helps to make the daily works of staffs effective.
6. Internal control helps the management to prepare and implement effective plans by providing correct and fact information.
7. Internal control helps to put moral pressure on staffs.

Disadvantages of Internal Control:

1. It involves expenditure which may not be affordable by the small organizations.
2. Internal control is concerned with routine transactions many times unusual transactions may be over looked.
3. The system of internal control may be weakened due to inefficiency in handling of the system.
4. There are chances of diverse objectives among employees in the departments and staff in charge of internal control.
5. Management may manipulate the operation of internal control system.

Elements, features characteristics principles of a good Internal Control System:

An effective internal control system should have the following factors:

1. **Competent and trust worthy staff:** people in charge of internal control system must be reliable and highly competent about the work. Lack of knowledge and dishonesty will spoil the efficiency of the system.
2. **Records of financial and other organizational plans:** A good internal control system must have good documentation system. Filing, recording, classifying, etc will help in this regard.
3. **Segregation of duties:** normally, there should be a separate department for internal control this reduces frauds, bias etc. normally, a clerk in charge of accounting function should not be in charge of assets also.
4. **Supervision:** proper reviewing of the operations of the company regularly makes the control system effective.
5. **Authorization:** all transactions must be properly authorized. In other words, the authority of each person should be well defined.
6. **Sound practices:** the company should have well established procedures, policies, delegations organizational manuals etc.
7. **Internal Audit:** it’s a part of internal control and it should be independent of internal check.
8. **Accounting Controls:** proper accounting information systems should be established so that the information relating to accounts is properly collected, recorded and accounts prepared.

Scope of Internal Control or Areas of Internal Control:

1. **General financial Control:** It's concerned with control over all finance functions i.e., planning, acquiring and investing funds and management of profits. It deals with accounting supervision recording etc of the finance department.
2. **Cash Control:** it's concerned with proper control over receipts payments and balance of cash. The control system must ensure that misappropriation of cash is prevented.
3. **Control over wages:** this includes maintenance of time records, wage records, and payment to workers. The main area of concern in this regard is the check payment to wages for the work not done and misappropriations of cash.
4. **Control over purchases:** the system of internal control regarding purchases should be developed in such a manner that purchasing accounting, handling and issuing of goods are properly controlled.

AUDITOR'S REPORT / AUDIT REPORT.

The main objective of audit is to report to the owners on the true and fair position of the business. Audit report is the medium through which an auditor expresses his opinion on the financial state of affairs of the clients business. It summarizes the results of the audit work conducted by the auditor.

Importance of Audit Report.

In case of a company management is separated from the ownership share holders appoint the auditor to check the accounts and submit a report to them. However, the report doesn't guarantee accuracy of the accounts. The auditor is neither a guarantor nor an insurer. In one of the cases it was held that "the auditor must not be held liable for not tracing fraud, when there is nothing to arouse their suspicion and when those frauds are perpetrated by the trusted servants of the company".

The auditor is expected to act honestly with reasonable skill and care. Audit report is an extremely significant document as share holders rely upon it. The auditor will be guilty of professional misconduct if he deliberately fails to disclose material facts known to him. Conceals misstatements and fails to obtain necessary information to complete his audit.

TYPES OF AUDIT REPORT.

1. **Clean Report:** Its also known as Unqualified Report. It is given by the auditor if he is satisfied with the fairness of Balance Sheet and Profit and Loss account with all the contents of the financial statements and he is satisfied with evidences, documents and explanation given by his clients.

Specimen of Clear Report.

To,
The Share Holders of ABC Ltd.

We have audited the attached Balance Sheet of ABC Ltd as on 31.03.2009 and also Profit and Loss account annexed there to for the year ended on that date.
1. We have obtained all the information and explanation which to the bet of our knowledge and belief were necessary for the purpose of audit.
2.Proper books of accounts are required by the law have been kept by the company so far as it appears from our examination of books and proper return adequate of our audit have been received from branches not visited by us.
3. The Balance Sheet and P&L account dealt with by his court are in agreement with the books of accounts and returns.
4. In our opinion and the to the best of our information and according to the explanation given to us the said Balance Sheet together with the notes thereon given the information required by Act of 1956 in manner so required and gives a true and fair view.

Date: Signed
Place: (Name, partner XY Associates)
Charted Accountant.

2. **Qualified Report:** When the auditor is not satisfied with the accounts presented to him if he finds any discrepancy in the recording of the transaction, if he thinks that the Balance Sheet and P&L account do not exhibit true and fair view of the business then he submits Qualified Report.

   It means he submits his report with certain qualification (observation) a qualified report may be submitted in many cases such as improper valuation of assets, inadequate or excess depreciation, not following accounting standards etc.

   The company Act doesn't lay down any specific requirement regarding the manner in which the auditor should qualify his report. It should not lead any confusion to the reader. Before submitting a qualified report he should discuss the issued with that of the management. He should see that qualified report is free from ambiguity, vague statements etc.

Specimen of Qualified Report.

To,
The Share Holders of ABC Ltd.

We have audited the attached Balance Sheet of ABC Ltd as on 31.03.2009 and also the P&L account of the company for the year ended on that date and report that:
1. We have obtained all information and explanation which to the best of our knowledge and belief were necessary for the purpose of our audit.
2. In our opinion proper books of accounts as required by law have been kept by the company so far as appears from our examination of the books subject to the comments given here under:-
In the absence of stock register, adjustments relating to balances on the registers have been accepted on the basis of management decision.
3. The Balance Sheet and P&L account dealt with by the report are in agreement with the books of accounts and returns.
4. Subject to the qualification given below in our opinion and to the best of our information and according to the explanation given to us the accounts together with the notes there on and documents attached there to give the information required by the company's Act of 1956 in the manner so required and give a true and fair view.
a. The provision for depreciation of fixed assets is inadequate.
b. Stock has been valued at market price which is higher than the cost price.

Date: Signed
Place: (Name, partner XY Associates)
Charted Accountant.

Contents of Audit Report.

The auditor's report includes the following basic elements, ordinarily in the following layout:

1. Title;
2. Addressee;
3. Identification of the financial statements audited;
4. Reference to the auditing standards opinion paragraph containing
5. Date of the report;
6. Auditor's address; and
7. Auditor's signature.

The difference between internal and external audit

While sharing some characteristics, internal and external audit have very different objectives. These are explained in the table below:

	External audit	Internal audit
Reports to	shareholders or members who are outside the organisations governance structure.	The board and senior management who are within the organisations governance structure.
Objectives	Add credibility and reliability to financial reports from the organisation to its stakeholders by giving opinion on the report	Evaluate and improve the effectiveness of governance, risk management and control processes. This provides members of the boards and senior management with assurance that helps them fulfil their duties to the organisation and its stakeholders.
Coverage	Financial reports, financial reporting risks.	All categories of risk, their management, including reporting on them.
Responsibility for improvement	None, however there is a duty to report problems.	Improvement is fundamental to the purpose of internal auditing. But it is done by advising, coaching and facilitating in order to not undermine the responsibility of management.

Definition of Internal Auditing:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Essentials for effective internal auditing are:

(a) Independence

The internal auditor should have the independence in terms of organisational status and personal objectivity which permits the proper performance of his duties

(b) Staffing and training

The internal audit unit should be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be properly trained to fulfil all his responsibilities

(c) Relationships

The internal auditor should seek to foster constructive working relationship and mutual understanding with management, with external auditors, with any other review agencies and, where one exist, the audit committee

(d) Due care

The internal auditor should exercise due care in fulfilling his responsibilities

(e) Planning, controlling and recording

The internal auditor should adequately plan, control and record his work

(f) Evaluation of the internal control system

The internal auditor should identify and evaluate the organisation's internal control system as a basis for reporting upon its adequacy and effectiveness

(g) Evidence

The internal auditor should obtain sufficient, relevant and reliable evidence on which to base reasonable conclusions and recommendations

(h) Reporting and follow-up

The internal auditor should ensure that findings, conclusions and recommendations arising from each internal audit assignment are communicated promptly to the appropriate level of management and he should actively seek a response. He should ensure that arrangements are made to follow up audit recommendations to monitor what action has been taken on them.

Test Check

Big business houses have a lot of transactions. So, it is very difficult to check all the transactions in detail. An auditor needs to prepare and present report in short period of time. So, an auditor checks the sample transactions and prepares and presents report to the concern authority which is known as 'Test Check'. An auditor checks the books of accounts of a particular time or area if there is no any doubt, s/he proves the account as true and fair, otherwise auditor checks in detail where s/he has doubts.

But if any errors or frauds are left out due to random sampling, auditor will be responsible for such losses. So, an auditor applies test check if internal check is effective in the organization.

Following points are to be taken into consideration while applying test check:

1. Sample should be selected from the various books of account and of different times.
2. Transactions related to beginning and ending period of particular year should be checked in detail.
3. Transaction related to cash and stock should be checked in detail.
4. Sample selection is to be made in random basis, not in planned way.
5. Detail check of Bank Reconciliation Statement is necessary.

<u>Verification and Valuation of Assets.</u>

A. <u>Intangible Assets:</u>

i) <u>Goodwill</u>: goodwill is an intangible assets representing the value of the reputation of the firm which enables it to earn more than normal profit. The value of goodwill varies with the earning capacity of the business.

When a business has been purchase and goodwill is paid for the auditor should verify the agreement with the vendors. Whenever a business is acquired, goodwill is the difference between the value of acquisition and cost of acquisition.

ii) <u>Patents:</u> patent rights should be verified with the certificates granting such rights. If a patent is purchased, he should verify the assignment deed. He should see whether the deed is registered in the name of his client and patents are the property of the client.

iii) <u>Copy Rights</u>: copy rights are those rights to produce or reproduce any creative work. The auditor should verify the agreement between the holder of the copy right and his client. Copy right is shown is BS at cost price less written off amount.

iv) <u>Trademarks</u>: they are registered brands. It gives the holder exclusive right to own the brand and protect it from imitation. An auditor should verify the certificate issued by the concerned authority, the fees paid for renewal etc trademarks are valued at cost price less written off amount.

B. Fixed Assets.

i) Land and Building: For verifying land and building the auditor should differentiate between free hold and lease hold properties.

a) In case of free hold land and building, the auditor should verify with the title deeds to ensure that the property is in the name of the client.

b) Lease Hold Property: In case if the property is held in lease he should verify the lease agreement and see whether its registered or not it is valued at cost less depreciation.

ii) Plant and Machinery: He should obtain a schedule of plant and machinery certified by responsible official. It gives all details about each machinery. He should compare the schedule with the plant register. If machinery is acquired under hire purchase he should verify the hire purchase agreement. If the machinery is imported he should verify the export license copy of invoice, permission of RBI from foreign exchange payment.

iii) Furniture and Fixtures: Furniture is a movable asset where as fixtures becomes a part of another asset. It any addition is made during the year, he should verify the invoice and pass book. He should also verify the schedule of furniture and see whether they are properly numbered and proper accounts are maintained. Repairs to furniture should be treated as revenue expenditure and hence debited to P&L a/c. furniture is always valued at cost less depreciation at a reasonable rate. He should verify the method of depreciation. The amount of depreciation varies with the usage.

C. Current Assets.

i) Cash in Hand: Cash in hand is verified by actually accounting it on the date of Balance Sheet. The counting must be done in front of the cashier. To avoid frauds the auditor must ask the cashier to deposit all the cash except petty cash into bank account. This makes verification easier. In case of temporary advances, enough care must be taken in verifying the delays.

ii) Cash at Bank:

The following steps are taken in verifying cash at bank:

i) Comparison of B.S as shown in the cash book and the pass book.
ii) Preparation of Reconciliation Statement.
iii) Obtaining a letter of confirmation from the bank

iii) Bills Receivable: B/R is the acceptances given by Debtors. The objectives of verifying bills receivable are:

i. To establish the accuracy of amounts.
ii. To know the validity of the bills.
iii. To know whether they are reliable and to see whether there is a fair disclosure in the BS.

iv) Book Debts/ Sundry Debtors: Book debts are to be classifies as good, bad and doubtful. The auditor should see the accuracy, validity, and collectability and confirmation letters directly from the debtors. For any balance for which no confirmation is received, he should carefully verify the account. He should see that proper provision is made for bad debts. Failing to do so the auditor will be held guilty for negligence.

v) Stock/ Inventories: Stock is the life blood of the business. It consists of stores and spares, raw materials, work in progress, and finished goods. If stock is incorrectly recorded, verified or valued, the P&L a/c doesn’t show correct balances. It also affects the BS if stock if overvalued profit is inflated and if its understated it encourages creation of secret reserves.

<u>While verifying stock</u>:

a. He should review the procedure for maintenance of stock and records.
b. Examine the efficiency of internal check and control system.
c. See whether stock verification process contains adequate safeguards against possible errors and frauds.
d. Test check the physical existence of a part of the stock. Stock is valued at cost price/ market price whichever is lower/less.

vi) <u>Investment:</u> It may consist of govt., bonds, shares, securities etc. The auditor should examine whether the company is authorized to make investments. He should see whether the legal formalities have been completed. If the investments are larger in number he should obtain the schedule of investments certified by a responsible official. The statement should include name of the investment date of purchase, book value, market price, rate and date of interest, tax deducted etc.

<u>Miscellaneous expenses and losses:</u>

1. **<u>Preliminary expense</u>:** all expenses incurred in the formation of a company are called preliminary expenses. The auditor should vouch the payments made and see whether these expenses are written off regularly. The portion of preliminary expense not written off will be shown in the balance sheet on the assets side.
2. **<u>Discount on issue of shares and debentures</u>:** whenever shares and debentures are issued at discount, the company shows discount amount of the asset side till it is written off. The auditor should verify the relevant accounts and documents and see whether discount on the issue in particular on the re issue of forfeited share is as per the provision so act.

3. **<u>Verification of liabilities</u>:** if liabilities are not properly exhibited account do not show fair view of the business. While verifying liabilities the auditor should ensure that:

a. all the liabilities in the Balance Sheet are actually payable.
b. They are actually recorded.
c. They have arisen out of natural business operation.
d. There is a proper disclosure.

He should obtain a certificated from the responsible official of the company about the existence of liability.

<u>Verification of Share Capital</u>: Share capital constitutes the amount contributed by the owners. He should verify the MOA, AOA, and Minutes Book of board meetings, cash book and pass book.

<u>Debenture</u>: A debenture is a certificate issued by a company acknowledging its debt to the authorized holder. It carries a fixed rate of interest. Usually paid once in 6months. The auditor should verify the minutes of directors meeting the authorizing the issue. He should also verify cash book, pass book etc.

i) **<u>Loans</u>:** Loans may be either secured or unsecured. The auditors should verify the MOA and AOA and verify the borrowing powers of the company. In case of mortgage loans, he should see that the assets are mortgaged as per the provisions of the law. Its advisable to get confirmation from lending institution with a respect to amount of loan, security, interest etc.

<u>Current Liabilities:</u>

i) **<u>Creditors</u>:** The auditor should obtain the confirmation statement from the creditors and compare this with the statement of creditors as sent by the company. He should verify purchase ledgers, invoice etc. It is advisable to have a test check of all purchases mode during the year.

ii) **<u>Outstanding Expenses</u>:** The auditor should obtain a statement of all outstanding expenses signed by a responsible official. He should see whether these expenses have been properly disclosed. He should ascertain the accuracy of the accounting records.

iii) **<u>Bills Payable:</u>** Bills Payable are negotiable instruments acknowledging the debt. He should get a statement of bills payable and compare it with the bill payable book. If any bills payable has been paid after the balance sheet date but before the audit, he should verify cash book and pass book. Such bills should not be included in the balance sheet.

iv) **<u>Contingent Liability</u>:** A future uncertain liability which is dependent on the happening of some event is called Contingent Liability. It may or may not arise in future. <u>Eg</u>: Bills receivable discounted claims against the company etc. the auditor should see whether all contingent liabilities are disclosed in the Balance Sheet.

Important Sections of Auditors; The Companies Act, 1956

- **Section 224:** Appointment and remuneration of auditors.
- **Section 224A:** Auditor not to be appointed except with the approval of the company by special resolution in certain cases.
- **Section 225:** Provisions as to resolutions for appointing or removing auditors.
- **Section 226:** Qualifications and Disqualifications of the Auditor.
- **Section 227:** Powers and Duties of Auditors.
- **Section 228:** Audit of accounts of branch office of the company.
- **Section 229:** Signature of Audit Report.
- **Section 230:** Reading and inspection of auditor's report.
- **Section 231:** Right of auditor to attend general meeting.
- **Section 232:** Penalty for non compliance with Section 225 to Section 231.
- **Section 233:** Penalty for non compliance by auditor with Section 227 to Section 229.
- **Section 233A:** Power of Central Government to direct special audit in certain cases.
- **Section 233B:** Audit of Cost Accounts in certain cases.