Centre for Distance and Online EducationPunjabi University, Patiala

Class : B.Com Part-III Semester: 5

Paper : BCOU-3506(Auditing)

Medium : English Unit : I

Lesson No.

:

Updated on 2 june, 2023

Syllabus of BCOU 3506T Auditing

BCOU3506T : AUDITING

Time allowed : 3 hours	Max Marks: 100
Pass Marks : 35%	Internal Assessment: 30
Periods per week : 6	External Assessment: 70

Instructions for Paper-Setters/Examiners

The question paper covering the entire course shall be divided into three sections as follows:

SECTION-A

It will consist of essay type questions. Four questions shall be set by the examiner from Unit-I of the syllabus and the candidate shall be required to attempt two. Each question shall carry 10 marks; total weight of the section shall be 20 marks.

SECTION-B

It will consist of essay type questions. Four questions shall be set by the examiner from Unit-II of the syllabus and the candidate shall be required to attempt two. Each question shall carry 10 marks; total weight of the section shall be 20 marks.

SECTION-C

It will consist of 12 very short answer questions from entire syllabus. Students are required to attempt 10 questions up to five lines in length. Each question shall carry 3 marks; total weight of the section shall be 30 marks

UNIT - I

Definition and Objectives of Auditing; Major Influences in the field of Auditing; Classes of Audit, Distinction between Audit and Investigation; Statements on Standard Auditing Practices (Brief Introduction only). Audit planning, advantages and limitations of audit. Internal Control, Internal Check and Internal Audit.

UNIT II

Audit Procedure: Vouching: definition, features , examining vouchers, Vouching of Cash book, Vouching of trading transactions, Verification and Valuation of Assets & Liabilities: Meaning, definition and objects, Vouching vs. Verification . Verification: Valuation of different asset and liabilities. Audit of Limited Companies: Company Auditor: Qualifications and disqualifications, Appointment, Removal, Remuneration, Rights, Duties and Liabilities. Audit Committee Auditor's Report : Contents and Types . Special Areas of Audit: Tax audit and Management audit, Recent Trends in Auditing

Course Outcome: After completion of this course students will learn about Objectives, and, procedures of audit. They will also learn about appointment, removal, remuneration, rights and duties of company auditor. Further student will learn about tax audit and Management audit.

R. S. Arya

PUNJABI UNIVERSITY PATIALA

B. COM. PART - III
SEMESTER-V

BCOU3506T

AUDITING

UNITS NO. 1

Centre for Distance and Online EducationPunjabi University, Patiala

LESSON NO. :

UNIT NO. 1

NOTE: Students can download the syllabus from department's web site www.pbidde.org

LESSON NO. 1.1

DEFINITION AND OBJECTIVES OF AUDITING

Objectives of Auditing

1.1.1 Objectives of the lesson

* To explain the meaning of audit
* To elaborate on the objectives and functions of auditing.
* To discuss the relationship of auditing with accounting.

1.1.2 Introduction :

Auditing, along with other disciplines such as accounting and law, as a subject fulfills all the knowledge that is required to enter into auditing as a profession. No business or institution can effectively carry on its activities without the help of proper records and accounts. Numerous transactions take place in daily business. The effects of all transaction have to be recorded and analysed to see results of the activities in achieving the objectives of the organisation. This would be impossible without a systematic record of transactions. Financial statements are the basis for appraisal of the management and for corrective action even closing down the organisation or a part of it. All this is possible only if the statements are reliable. Decisions based on wrong accounting statements may be very harmful to the business. For example, if the business has really earned a loss, but because of wrong accounting the annual accounts show a profit, the proprietor may take the decision to keep the business even on a loss.

Thus, from the point of view of management itself, authenticity of accounting statements is essential. It is even more essential for those who have invested their money in the business but cannot take part in the management, e.g. share holders in a company. Such persons certainly need an assurance that the annual statements of account ensures that the accounting statements are authentic and reliable.

1.1.3 Development of Auditing :

The first Companies Act was enacted in 1857 which provided for voluntary annual audit of limited companies. The Companies Act of 1913 made audit compulsory for every limited company. It also laid down provisions relating to qualifications, rights, duties and appointment of the company auditor. After independence, the Companies Act of 1956 enlarged the scope of auditor's work and laid down other detailed provisions with regard to audit. Other legislations like cost and works Accountants Act, 1959 and the Income-Tax Act, 1961 have further broadened the scope of auditor's work.

The first step towards regulation of auditing profession in India was taken up by the provincial Government of Bombay. In 1918, it started a scheme of conducting qualifying examination for auditors known as Government Diploma in Accountancy (GDA) and an articleship of three years was prescribed. Other provincial governments, too, started similar schemes for training the entrants to the profession. Persons holding such diploma were qualified to act as an auditor in any province of the country. In order to maintain uniform set of standards throughout the country, the Companies Act, 1930 vested the entire control and regulation of the profession in the hands of the Central Government. In 1932, the Central Government established the Indian Accountancy Board for exercising the powers vested in it by the said Act. After independence these powers were transferred to the Institute of Chartered Accountants of India (ICAI) through the Chartered Accountants Act, 1949. It also conducts the qualifying examinations, grants certificate of practice and exercises disciplinary jurisdiction over its members.

As a result of globalisation of business operations in the last century, efforts are being made towards the development of coordinated worldwide accountancy profession. Two organisations, which are doing commendable job to achieve this goal are the International Accounting Standards Committee (IASC) and the International Federation of Accountants Committee (IFAC).

ISAC has been successfully restructured to create an International Accounting Standards Board (IASB). ICAI is a member of both IASB and IFAC. In recent years, ICAI has made a definite move towards bringing the country's accounting and auditing standards in line with international standards.

1.1.4 Meaning and Definition of Auditing

Auditing is the verification of financial position as is disclosed by the balance-sheet and profit and loss accounts of a business.

Auditing is an examination of accounts to ascertain whether the balance sheet and profit & loss account give a true and fair view of financial position and profit & loss account of the business.

Auditing is the intelligent and critical test of accuracy, adequate dependability of accounting data and accounting statements.

According to A.W. Hanson, "An Audit is an examination of such records to establish their reliability and reliability of statement drawn from them."

R.K. Mautz has defined auditing as being, concerned with the verification of accounting data, determining the accuracy and reliability of accounting statements and reports.

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

The above definitions provide some information about Auditing. It clarifies the meaning of Auditing as follows;

1. It is a complete, intelligent, systematic and critical examination of accounting data.
2. The examination of accounts may be made throughout the year.
3. It is done with the help of relevant records, documents, vouchers, information and explanation from the authorities.
4. The Auditor has to satisfy himself and report whether or not :-

(a) The Profit and Loss accounts reveal true and fair profit or loss of the period.

(b) The Balance-Sheet exhibits a true and fair view of financial position of the concern.

(c) Books of accounts have been maintained and accounts have been prepared as per the provisions of law.

In a nut-shell, auditing is the process of checking and vouching the accounting data and systems to investigate the truth and report thereon as per the requirements of his appointment.

1.1.5 Functions of Auditing

Important functions of Auditing can be summed up as follows :

1. Examining documentary evidences to establish the accuracy of recorded transaction.
2. Reviewing systems and procedures of business e.g. LIFO, FIFO method adopted for recording books of account.
3. Reviewing the system of accounting and internal control.
4. Checking of legal formalities.
5. To verify the valuation and existence of assets.

6. Checking mathematical accuracy of financial statements.
7. Reporting to what extent accounts exhibit true and fair view.
8. To verify the distinction between capital and Revenue items.
9. Recommendations, if needed.

Self Check exercise 1 : What is auditing? Explain its functions.

1.1.6 Objectives of Auditing

Objectives of Auditing may be classified into two parts i.e.

1. Main Objectives, and
2. Subsidiary objectives.

1.1.6.1 Main Objectives of Auditing :

The main objectives of auditing in the case of companies are laid down in sec. 227 of the Companies Act. This section requires a company auditor to state whether in his opinion ;- .

(i) Balance-sheet gives a frue and fair view of the state of companies' affairs as at the end of the financial year, and

(ii) The Profit and Loss Account gives a true and fair view of the Profit and Loss for the financial year.

This type of reporting is not compulsory in the case of non-company auditors unless the terms of agreement of the appointment of auditor so requires,

The Auditor has to conduct an independent review of financial statements about their reliability to form such an opinion. The auditor must examine the following :-

(a) Assess the systems of internal control.
(b) Verify the accuracy of posting, balancing etc.
(c) Confirm the validity of transaction with supporting documents.
(d) Ascertain all statutory requirements of keeping books and records.

1.1.6.2 Subsidiary Objectives of Auditing :- Subsidiary objectives include:

(a) Detection and prevention of errors.
(b) Detection and prevention of fraud.

Detection and Prevention of Errors :

An error is an unintentional misstatement in the accounts and records made by the employees of the firm. An error is not deliberate act. Errors may be classified as under :

(a) Clerical errors-These are of the following types :

(1) Errors of Omission, and
(2) Errors of Commission.
(3) Errors of Principle.
(4) Compensating Errors.

1. Errors of Omission :

If a transaction has been omitted from being entered in the books of accounts, it is known as error of Omission. Where a transaction has been totally omitted, it does not affect the trial balance e.g. purchase of Rs. 1,000 has not been recorded. It means both debit and credit aspects of the transaction are equally omitted and arithmetic accuracy of trial balance is not affected. Errors of omission may also arise when an item remains partially recorded e.g.

(i) Rent paid for 11 months had been recorded but for the 12th month which is outstanding has not been recorded in the journal. This will affect the trial balance,

(ii) Error of mission will also arise if a transaction has been recorded in the, journal but not posted in the ledger.

2. Errors of Commission :

If a transaction has been incorrectly recorded in the journal or posted in the ledger, it is an error of commission. Examples are wrong entries in the books of original entry, posting additions, casting and carry forward. Some of such errors can be detected when the trial balance does not agree.

3. Errors of Principle :

Errors of principle generally arise when some fundamental principles of sound accountancy are not properly observed in recording a transaction. Such errors may, thus, arise on a account of lack of correct knowledge of the principles governing the preparation of accounts. Examples of such errors are : treating revenue expenditure as a capital expenditure or vice-versa, wrong valuation of assets and provisions for liabilities, for instance wages paid for installation of machinery, in this case wages is capital expenditure. But if it is treated as revenue expenditure, it is an error of principle. These errors do not affect trial balance.

4. Compensation Errors :

These errors arise when two or more errors exactly counter balance the effect of each other. In other words, when errors are committed in such a way that one error compensates the other so that the net effect of all such errors is nil. The trial balance will, therefore, remain unaffected. For instance, omitting to post Rs. 300/- of the debit side of an account may be compensated by under posting of Rs. 300/- on the credit side of some other account.

Thus, all the errors, on the debit side may total up to the exact amount of errors committed on the credit side and will not disturb the total of trial balance.

Detection and Prevention of Fraud

Errors are generally innocently committed where as frauds are intentional with a view to defraud. Frauds may be committed in the following ways :

1. Embezzlement of cash :

This misappropriation of cash is done by (a) omitting to enter cash received, (b) entering less amount of cash than actually received, (c) inflating payment i.e. showing more amounts of payments than actual, (d) showing fictitious payments. To detect these types of frauds, an auditor must thoroughly check the cash book.

2. Misappropriation of Goods :

It is quite difficult to detect misappropriation of goods. Thus, proper system of keeping records of purchases, sales, stocks etc. should be devised. Perpetual inventory system may be of great use in detecting misappropriation of goods.

3. Fraudulent Manipulation of Accounts :

This type of fraud is usually committed by responsible persons like directors, managers, etc. and it is more difficult to detect because these persons are at the helm of affairs and are presumed to be honest and trustworthy. The object of this type of fraud may be to avoid payment of taxes and to give a wrong picture about the success of business to competitors, to mislead a prospective of the business, etc. Some of the ways of committing this type of fraud are :-

- (a) By under-valuation or over-valuation of assets and liabilities.
- (b) By providing excessive depreciation.
- (c) By showing fictitious receipts and payments.
- (d) By omitting certain expenses or incomes.
- (e) By showing fictitious purchases of sales, etc.

Auditing has become important in present day business world and even organisations not covered by the Companies Act2013 get their financial statements audited. It has become a necessity for every commercial and even non-commercial organisation. People are interested to know the true facts about their business which are helpful to them for future planning and improvements in operations.
Auditing is important for every type of the business organisations.

1. For the owners of the Business and shareholders

- (a) In case of sole trader, he can depend on the audited accounts and can value his business on the basis of audited accounts for the purpose of sale of business or for admitting a new partner.
- (b) Dispute over the correctness of profits can be avoided, especially in the case of partnership firm, audited accounts will be useful valuing goodwill and business on admission and retirement of a partner.
- (c) Shareholders would like to know whether the amount invested by them is properly used or not.

2. For the Management

- (a) It helps the management in detecting and preventing errors and frauds.
- (b) Claims due to fire, theft and accident can be estimated from audited accounts.
- (c) It keeps the accountants and staff vigilant while preparing books and records as they know in advance that all the accounts are to be audited.

3. For the creditors

Long-term and short-term creditors can depend on audited financial statements while taking decision to grant credit to business houses.

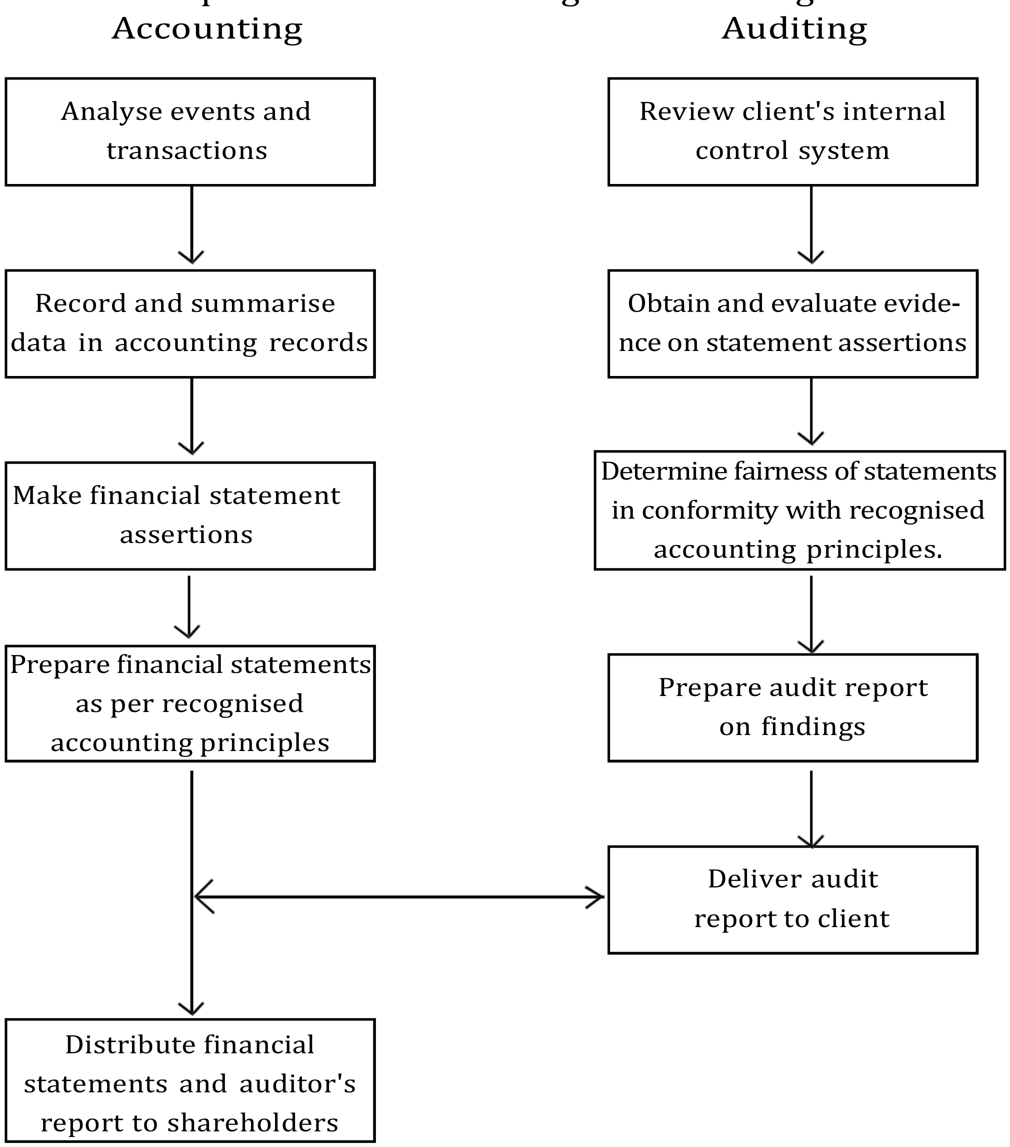
4. For the Government Bodies

- (a) Taxation authorities depend on audited statements in assessing the income-tax, sales tax and wealth-tax liability of the business.
- (b) Audited accounts can serve as an evidence in a court of law.

5. For Others

Audited accounts can be used by insurance companies to settle the claims arising on account of loss by fire.

1.1.7 Relationship between Accounting and Auditing



Source : Kell and Ziegler, "Modern auditing," John Wiley and Sons, 2nd Edition, p. 15.

Selfcheck exercise 2 : What are the main objective of auditing?

1.1.8 Summary

From ancient times through industrial revolution, the term 'audit' was associated with 'hearing of account'. With the emergence of limited liability corporates in the eighteenth century as a result of subsequent legislations, auditing started getting closely linked with examination of accounts, books and relevent documentary evidence. Audit includes any evaluation process undertaken to establish adherence to certain norms for accomplishing a stated object.

1.1.9 Questions for Exercise

1. What do you understand by 'auditing'? Explain its objectives.
2. Distinguish between fraud and error.
3. Describe in brief the main classes of error & frauds.
4. Write shirt note on:
   a) meaning of auditing
   b) functions of auditing

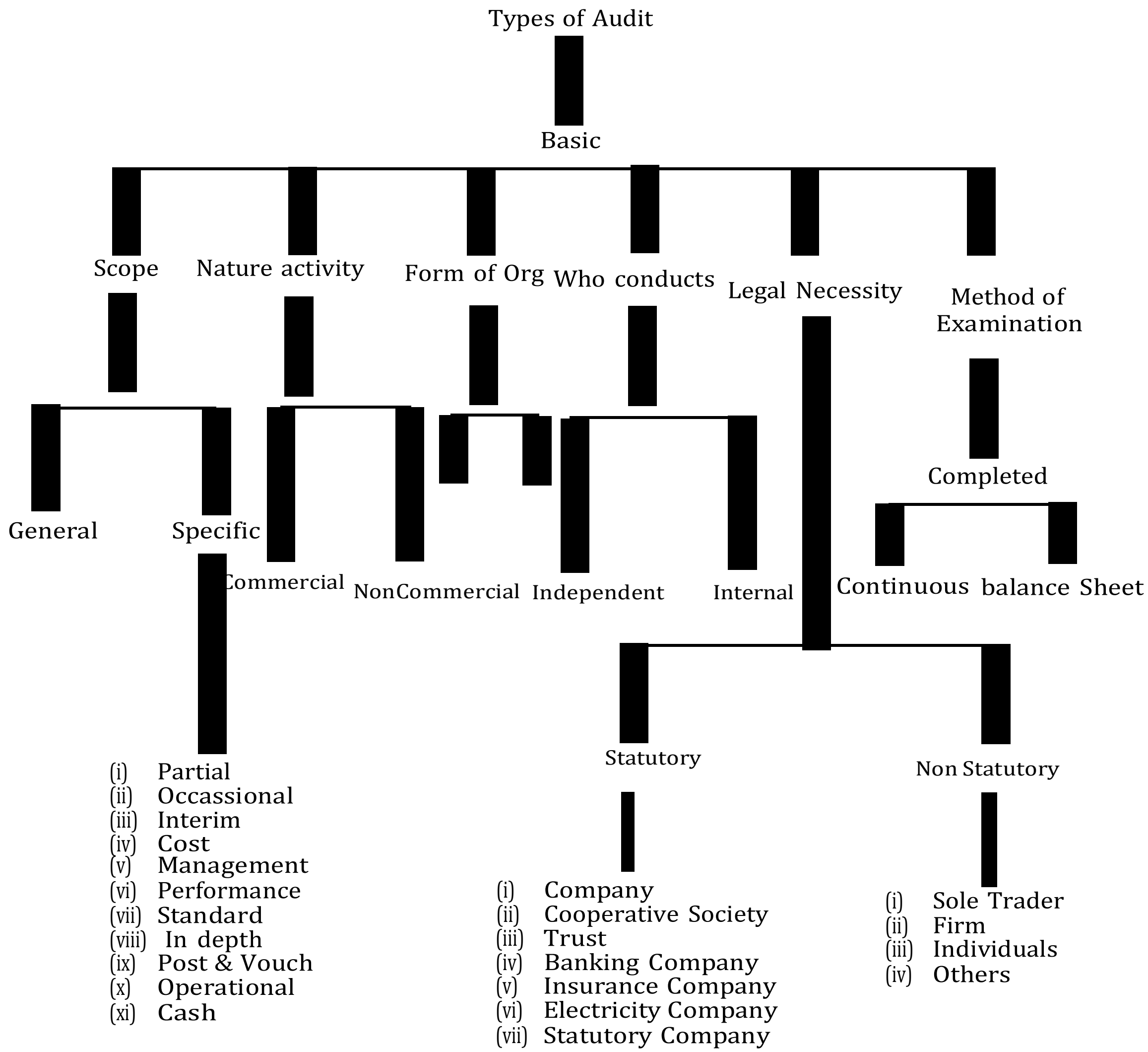
1.1.10. Glossary

GDA- Government Diploma in Accountancy
ICAI- Institute of Chartered Accountants of India
IASC- International Accounting Standards Committee
IFAC- International Federation of Accountants Committee

1.1.11. SUGGESTED READINGS

Contemporary Auditing	Kamal Gupta
Auditing Theory and Practice	Pardeep Kumar, N.K. Sahni and Baldev Sachdeva.

Kinds of Audits



1.2.1 Objectives of the lesson :

* To study the various types of audits under different classifications.
* To compare and constrast various types of audits.

Types of Audit

Audit is not legally obligatory for all types of business organisations or institutions. On this basis, audits may be of two broad catergories, i.e.

(a) Audits according to organizational structure of business.

(b) Audits from practical point of view.

1.2.3.1 Audits According to Organisational Structure of a Business :

The Audit of accounts is dependent upon the organisational structure of a business. There are different types of audit on the basis, which are;

(1) Audit Required Under Law :

The various organizations which require audit under law, are the following :

(a) Limited Companies governed by the Companies Act, i.e. Companies Act, 1913 made legally compulsory audit of limited companies in India.

(b) Banking Companies governed by the Banking Regulation Act.

(c) Co-operative Societies registered under the Co-operative Societies Act.

(d) Public and Charitable trusts registered under Religious Act.

(e) Electricity and Gas Supply Companies.

(f) Societies registered under the Societies Regulation Act.

(g) Corporations set-up under an Act of Parliament such as the Life Insurance Corporation of India, Industrial Finance Corporation of India, etc.

(2) Government Audit :

The verification and checking of documents of Government departments and organizations is called Government Audit. Government has a separate department of audit.

Comptroller and Auditor General of India appoints various Auditors, who are not public auditors, so they can not be appointed as public Auditors. They are appointed for Government concerns and they work according to Government' rules and regulations. .

(3) Private Audit or Voluntary Audit :

The voluntary audit is the audit of accounts of sole Traders, Partnership Firms, Hindu Undivided Families, etc. in respect of such accounts there is no basic legal requirement of Audit. Many of such enterprises, as a matter of internal rule require audit. There may be any notice to get advance of independent professional audit. This is the reason, why large number of sole traders and partnership business get their accounts audited.

INTERNAL AUDIT

Internal Audit is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. Internal Audit is a thorough examination of the accounting transactions as well as that of the system; according to which these have been maintained. The system contains adequate safe-guards to check any leakage of revenue or misappropriating of property, or assets and the operations have been carried out in conformity with the plans of the management.

1.2.3.2 Audits from Practical Point of View :

It covers all the audits which are practically conducted by business organisations.

(i) Continuous Audit :

A Continuous Audit is a detailed audit which involves a detailed examination of all the transactions by the auditor attending at regular interval, say weekly, fortnightly, or monthly during the financial period. At the end of the year, auditor checks the profit and loss account and the Balance-Sheet.

Advantages of Continuous Audit

(a) Detailed and intensive checking;
(b) Information regarding working of an enterprise;
(c) Early detection of Errors and Frauds;
(d) Moral Check on employees;
(e) Efficiency of Employees increases; and
(f) Improvement in accounting system;

(i) Disadvantages of Continuous Audit

(a) Chances of alteration in accounts after audit;
(b) Hurdle in working of business;
(c) It is an expensive process;
(d) Bad moral effects on employees; and
(e) Negligence in work.

Suggestions to Overcome its Shortcomings

(a) Clear instructions arc necessary for every type of work;
(b) Detailed plans for carrying out audit;

(c) Use of secret code marks; and

(d) No interference in the work of an auditor.

By using the precautions given above the disadvantages of continuous audit can be made minimum.

1.2.3.3 Self check Exercise

1 : What is internal Audit?

1.2.4 Distinction between Continuous Audit & Periodical Audit

1. In continuous Audit, the auditor's staff visits and checks the accounts frequently, whereas in periodical audit, the auditor's staff visits the business only once in a year after the accounts are closed.
2. Under continuous audit, the client's staff becomes more efficient and regular while in periodical audit, it may not be so because the client's staff knows that the audit work will commence only after the close of financial year.
3. After the transaction is recorded, audit staff checks and verifies it under continuous audit, whereas periodical audit commences after the closure of accounts.
4. Continuous audit comes to an end with the close of the accounting period whereas periodical audit commences after the accounts are closed.
5. Continuous audit is very expensive while periodical audit is economical.

(ii) Final or Completed Audit

This is also known as Annual or Periodical Audit and is done at the end of the financial or trading year, when the final accounts are prepared. It begins when the accounting for a period ends. The audit work is usually finished in one continuous session. Under this Audit, auditor checks the accounts only in one visit.

Advantages of Final Audit

(a) It is helpful for small business.

(b) It is convenient at the time of small information.

(c) It is less expensive than continuous Audit,

(d) Helpful in saving time.

(e) Undue collusion cannot be established between the auditor and the clerks.

Disadvantages of Final Audit

(a) Under this system errors are found only after the books are closed.

(b) Detailed checking of accounts is not possible.

(c) Delay in getting auditor's report.

(d) Final Audit is not suitable for big concerns.

(e) Under this system, management affects the work of independent Audit because auditors are appointed by the management, so the management misuses the powers.

(iii) Interim Audit

This is an audit which is conducted in between two annual audits, with a view of find out interim profits to enable the company to declare an interim dividend.This type of audit is good where publications of the interim audit figures is necessary. It is also useful in completing final audit quickly.

(iv) Balance-Sheet Audit

Balance-sheet Audit consists mainly of the verification of the items of assets and liabilities appearing in the balance sheet as Land and Building, Plant and Machinery, debtors, creditors, share capital, reserves etc. It is quite suitable for small and medium sized business.

(v) Cash Audit

When a sole trading firm or any other institution of business appoints an auditor for only cash transactions i.e. for cash receipts and cash payments it is called Cash Audit. Under this audit, the auditor uses vouchers relating to cash receipts and payments to check the accounts because its work is only limited to check cash book. He submits his report under these restrictions. He can mention the fact in his report.

(vi) Cost Audit

Cost audit is the verification of the correctness of the cost accounts and of the adherence to the cost accounting plan.

Cost audit is performed in some special circumstances but with the purpose to rectify the cost accounts so as to ensure how far cost accounting plans have been adhered to. . .

Advantages of Cost Audit

(a) Cost audit saves money.
(b) Cost audit has strict control on cost.
(c) It is helpful in competition.
(d) It is the basis of price fixation.

(vii) Management Audit

Management audit is the audit of all aspects of the management of a business concern. Today, the world is full of competition, so only the audit of financial accounts is not sufficient.

The checking of every field of management from time to time can show the results of management. It includes the examination of every activity of a business i.e. plans, objectives, means of operations, utilisation of physical resources, organisational pattern co-ordination of various activities of management including books to prepare a report stating whether the predetermined targets and objectives have been achieved or not.

Advantages of Management Audit

(a) It is helpful for the management to operate business more effectively.

(b) With the help of management auditor's report, decisions can be taken by the management quickly and effectively.

(c) It will boost up the morale of employees.

(d) Due to management audit, employees work efficiently and actively.

Management audit is helpful in improving the performance at all levels, because it is connected with every aspect of working of a business.

1.2.5 Distinction Between Auditing and Investigation

Auditing must not be confused with investigation. This similarity between the two is that, both are examination of books of accounts. But there is lot of difference between the two which is as follows :-

AUDIT	INVESTIGATION
1. Audit is carried out to find out whether the balance sheet of a concern is properly drawn up and it exhibits a true and fair view of the state of affairs.	1. Investigation is the examination of the books of accounts for a purpose.
2. Audit is conducted on behalf of the owners.	2. Investigation is usually, carried out by shareholders or on behalf of the outsiders.
3. Auditing usually covers a period of one year.	3. Investigation covers a longer period say three years etc.
4. Auditing in the case of companies is compulsory.	4. Investigation is voluntary or compulsory depends upon the needs of some purpose in view.
5. Audited accounts are not audited again except in certain special case.	5. Investigation may be conducted even though accounts have been audited.
6. Audit is required by every type of company big or small.	6. Investigation depends upon different situations.
7. Area under audit is Limited.	7. Area under investigation is very wide.
8. Auditing is only checking and verification of accounts.	8. Investigation may be helpful in the valuation of shares of a limited company.
9. Audit can be done by any Accountant.	9. Investigation can be done only by senior Chartered Accountant.
10. Audit is done only through proper document and other methods.	10. Investigation is done to see behind the books
11. Auditor's interest is to rectify and to show the actual position to the appointer	11. Investigator's interest is to check the errors.

(viii) Performance Audit & Propreity Audit

The propriety audit is an audit of higher level as it examines that:

(a) the appropriations are validly made;
(b) there are no leakages of revenue;
(c) there is no wastage of funds;
(d) the legal requirements are complied with;
(e) the activities are in the best interest of business;
(f) the assets are safe.

(ix) Occassional Audit

It is conducted as a special event, normally in those organisation where routine audits are not taking place.

(x) Standard Audit

The standard audit is defined as, "a complete check and analysis of cetain items and, contingent upon effective check, an appropriate test check on remaining items, the whole of the work being in accordance with general audit standards quite adequate to justify an unqualified opinion."

(xi) Audit in Depth

This audit is a type of sample checking. In this audit, selected transactions are subjected to a detailed stepwise verification. For e.g. in case of a purchase transaction, the auditor will examine all the stages through which a purchase transaction is completed and the documents that arise in the process. The focus will be on the requisition slip, clearance of authorising officer, quotations or tenders submitted by suppliers, purchase order, received note, goods inspection note, entries in the bin card and stores ledger.

(xii) Post & Vouch Audit

This audit involves verification of all individual transactions. Every transaction is examined from the book of original entry and its posting in the ledger. The auditor uses different types of ticks for each aspect of examination like posting, totalling, balancing etc. This type of audit can be adopted in small organisations. (xiii)

Operational Audit

This audit aims at improving the operations of business. It helps the management in the following way:

(i) To make recommendations for the improvement of profitability of the organisation.
(ii) To help as achieving other objectives of business such as workers's satisfaction in company's image.

1.2.5.1. Selfcheck exercise 2

1. What is periodical audit?

1.2.6 Summary :

The definition of auditing is sufficiently broad to encompass various types of audit. Different bases can be adopted to classify audits to gain a better Understanding of their features. Different types of audits have been discussed alongwith their advantages and disadvantages.

1.2.7. Glossary

IASB-InternationalAccountingStandardsBoard

1.2.8. Questions for Exercise :

1. Distinguish between Internal Audit and Statutory Audit.
2. Distinguish between periodical audit and continuous audit.
3. Write short notes on :
   1. Interim Audit
   2. Balance sheet Audit
   3. Final Audit
   4. Post & Vouch Audit.

1.2.9. SUGGESTED READINGS

1. Contemporary Auditing : Kamal Gupta
2. Auditing Theory & Practice : Pardeep Kumar, K.K. Sahni and Baldev Sachdeva

LESSON NO. 1.3

STATEMENTS ON STANDARD AUDITING PRACTICES (SAP)

Structure :

1.3.1 Introduction :

The SAPs apply whenever an independent audit is carried out. While discharging their attest functions; it will be the duty of members of the Institute to ensure that SAPs are followed in the audit of financial information covered by their audit reports. If for any reason the auditor has not been able to follow SAPs, he will point out material departures in his reports. It is expected that SAPs will be followed in the audits commencing on or after the dates specified in the statement. The SAPs are mandatory from the effective date mentioned in the statement. It is obligatory for the members of the Institute to adhere to these statements while carrying out audit. The SAPs of AAS are issued under the authority of the Council of ICAI.

Council of ICAI at its 226th meeting held in New Delhi in August 2002 ended the 'Auditing Practices Committee (APC) as Auditing and Assurance Standards Board (AASB). The Council also changed the name of Statement on standard Auditing Practices (SAPs) as 'Auditing and Assurance Standards AAS). Therefore, the name Auditing and Assurance Standards (AAS) should replace SAP's.

1.3.2 SAP-1 Basic Principles Governing an Audit (AAS 1) :

1. The establishment describes the basic principles which govern the auditor's professional responsibilities and which should be complied with, whenever an audit is carried out.
2. An audit is the independent examination of any entity.
3. Compliance with the basic principles requires the application of, auditing proceeds and reporting practices appropriate to the particular circumstances.
4. The auditor should. be straight forward, honest and sincere in his professional work.
5. The auditor should respect the confidentiality of information acquired during the course of his work.
6. The audit should be performed and the report prepared with due professional care by persons who have adequate training experience and competence in auditing .
7. He can rely on the work carried out by others, but will be responsible for his

assessment: and should be careful in relying upon the work performed by others.

8. The auditor should: document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.
9. The auditor should plan his work to enable an effective audit in an efficient and timely manner.
10. The auditor should obtain sufficient, appropriate evidence to draw reasonable conclusions, on which to base his opinion~

1.3.3 SAP-2.Objective and Scope of the Audit of Financial Statements (AAS 2) :

1. The objective of an audit of financial statements prepared within a frame work of recognized accounting policies, practices and relevant statutory requirements is to enable the auditor to express an opinion on such financial statements. The auditor's opinion helps determination of the true and fair view of the financial position & operating result of the enterprise.
2. While the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for the preparation is of the management of the enterprise. .
3. The scope of an audit of financial statements will be determined by the auditor having regard to the terms of engagement, the requirement of the relevant legislatipn and pronouncements of the Institute.
4. The audit should be organized to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements being audited. The relevant information shall be properly disclosed.
5. The auditor assesses the reliability and sufficiency of the information by-
   (a) Making a study and evaluation of accounting systems and internal controls
   (b) Carrying out such other tests and enquiries as may be required.

1.3.4 SAP-3 Documentation (AAS-3) :

1. Documentation, for the purpose of this statement, refers to the working papers prepared or obtained by the auditor and retained by him in connection with performance of his audit.
2. Working papers help in the planning and performance of the audit, in supervision and review of the audit work and provide evidence of the audit work performed to support the auditor's opinion.
3. Working papers should record the audit plan, the nature, timing and extent of auditing procedures performed and the conclusion draun from the evidence obtained.
4. The working papers should be designed and properly organised to meet the circumstances of each audit and auditor's needs in respect thereof.
5. The working papers should be sufficiently completed and detailed for an auditor to obtain an overall understanding of the audit.

6. All significant matters which require the exercise of judgement, together with auditor's conclusion, should be included in the working papers.

1.3.5 SAP-4 The Auditor's Responsibility to consider Fraud and error in an Audit of Financial Statement (AAS-4) :

1. When planning and performing audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud and error.
2. Misstatements in the financial statements can arise from fraud or error. The term "error" refer to an unintentional misstatement in the financial statements, including the omission of an amount.
3. The term "fraud" refers to an intentional act by one or more individuals among management, these charged with governance, employees, or third parties involving the use of deception to obtain an unjust or illegal advantage.
4. Two types of intentional misstatements are relevant to the auditor's consideration of fraud-misstatement resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.
5. Fraudulent financial reporting involves international misstatements or omissions of amounts or disclosure in financial statements to deceive financial statement.

1.3.6 SAP-5 Audit Evidence (AAS 5) :

SAP-l states, "That auditor should obtain sufficient appropriate evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions there from on which to base his opinion on the financial information. Compliance procedures seek 'reasonable assurance', while substantive procedures seek 'complete accuracy'. 'Sufficiency' refers to the 'quantum' of evidence and appropriateness refers to 'relevance and reliability'. The judgement of auditor will be influenced by number of factors like, nature and materiality of the item, reliability of internal control, experience regarding business, size of business etc

1.3.7 SAP-6 Risk Assessments and Internal Control (AAS-6)(revised)) :

The purpose of the statement or standard is to establish standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk.

1. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to acceptable low level.
2. The audit risk means the risk that the auditor gives an inappropriate audit opinion when the 'financial statements are materially misstated. It has three components- inherent risk, control risk and detection risk.
3. Inherent risk is the susceptibility of an account balance (individual or aggregated) to materially effect, assuring that there were no related accounting controls.

4. Control risk, is the risk that a misstatement will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.
5. Detection risk is the risk that the substantive procedures will not detect a misstatement that exists in an account balance.
6. The system of internal control should be continuously under the supervision of management.
7. The auditor is concerned only with those policies and procedures within the accounting and internal control systems that are relevant to the assertions made in the financial statement

1.3.8 SAP-7 Relying upon the work of an Internal Auditor (AAS 7) :

The purpose of this standard is to provide guidance as to the procedures which should be applied by the external auditor in assessing the work of the internal auditor for the purpose of placing reliance upon that work. While the external has sole responsibility for his report and determination of the nature, timing and extent of extent auditing procedures, much of the work of the internal auditor may be useful to him in his examination of the financial information.

1. The scope and objectives of internal audit vary widely and are dependent upon the size and structure of the entity. Normally he operates in ~ne of the following areas (a) review of accounting systems and related internal controls (b) examination for management of financial audit operating systems (c) examination of the economics efficiency and effectiveness of the operations (d) physical examination and verification.
2. The work of the internal auditor may be useful to the external auditor in determining the nature, timing and extent of the procedures.

1.3.9 SAP-8 Audit Planning (AAS-8) :

Audit plans should be made to cover among other things (a) acquiring knowledge of the client accounting systems, policies. and internal control procedures; (b) establishing the expected degree of reliance to be placed on internal control (c) determining the nature, timing and extent of the audit procedures to be performed and (d) co-coordinating the work to be performed. Plans should be further developed and revised as necessary during the course of the audit.

In planning his work he will consider complexity of the work involved.

1. the auditor needs to obtain a level of knowledge of the client's business acquire knowledge from the previous year's working papers and identify the matters that might require special attention he should consider all relevant factors. While determining an overall audit plan.
2. When the auditor uses the work in his capacity as an expert rather than delegating the work to an assistant.
3. During the audit the auditor may seek to obtain, in conjunction with the client or independently for valuation of certain types of assets, determination

of quantity and physical conditions of certain assets, for actuarial valuation, measurement of work completed or legal opinion on certain matters etc.

4. While deciding to use the services of expert, he should consider materiality of then batter, complexity of the issue and audit evidence available.
5. While deciding the expert, his professional qualification, experience and reputation should be kept in mind. He should also evaluate the objectivity of the work of an expert

1.3.9.1. Self check exercise-1

1. Explain AAS-8

1.3.10 SAP-10 Using the Work of another auditor (AAS-I0) :

The statement deals with the cases, where an independent auditor, uses the work of another auditor with respect to the financial statements of one or more divisions and branches. This deal with the cases where the principal auditor uses the work of other auditor and not the cases of joint auditor while using the work of another auditor, the principal auditor should perform the following procedures:

1. Advise the other auditor about the use that is to be made of his work in the report. He should point out areas for special consideration and the time table. He should point out significant accounting, auditing and reporting requirement and enquire about the scope and limitations, if any of the other auditor's work.
2. He is not required to evaluate professional competence.
3. He should document in his working papers the financial components which were audited by other auditors.
4. He should co-ordinate his work with other auditors.
5. He should pay due attention to the qualifications, if any made by other auditors.
6. He shall not be responsible for be work assigned to other audit

1.3.11 SAP-11 Representations by Management (AAS-11) :

The purpose of the standard is to establish standards on the use of management representations as audit evidence, the procedures to be applied in evaluating and documenting management representations, and the action to be taken if the management refuses to provide appropriate representation in this regard:

1. He should obtain acknowledgement that the management takes the responsibility of appropriate preparation and presentation of the financial statements.
2. He should exercise his professional judgement regarding the matters for which representations of the management are required. He should evaluate t e representations made by management and seek corroborate audit evidence from sources inside or outside. However, representations are not substitutes for audit evidence except, where the matter concerns only 'intention' confined to only circles of the management.

1.3.l2 SAP-12 Responsibility or Joint Auditors (AAS-l2) :

The standard deals with the professional responsibilities of the auditors, who undertake the assignment jointly and report jointly, particularly in the case of large firms:

1. Joint auditors should divide the work on the, basis of mutual discussions. Some areas may not be divisible on any basis; there the task should be performed jointly. Where one auditor comes across information which is solvent to the area of the other auditor, he should communicate the information to him
2. Each joint auditor is responsible only for work undertaken by him. They will be jointly as severally liable for the work undertaken by others jointly.
3. A significant part of the audit work involves obtaining and evaluating information and explanation4 from the management. The responsibility is shared by the joint auditors unless agreed upon otherwise.
4. Each auditor has the right to presume that the other joint auditors have performed their part of work in accordance with generally accepted' audit procedures.
5. Normally the joint auditors are angle to arrive at an agreed report.

1.3.l3 SAP-13 Audit Materiality (AAS-l3) :

The purpose of the standard is to establish standards on the concept of materiality and its relationship with audit risk which should be considered by the auditor while conducting audit.

1. Information is material if it misstatement could influence the economic decisions of users take on the basis of financial information. It depends upon the size and the nature of the item. The assessment of what is material is a matter of professional judgement.
2. The concept of materiality recognizes that some matters either individually or in the aggregate ate relatively important for true and fair presentation of financial informal on in accordance with recognized accounting principles and policies.
3. Informing his opinion on the financial information, the auditor should consider whether the effect of aggregate of uncorrected misstatements material or not.
4. If the aggregate of the uncorrected misstatements that the auditor has identified approaches the materiality level, he should consider requesting the management to adjust the financial information for known financial misstatements. If the management refuses to do the need-full he should give a qualified report.

1.3.14 SAP-14 Analytical Procedures (AAS-I4) :

The purpose of the standard is to establish standards on the application of analytical procedures during an audit. The auditor should apply these procedures at the planning and overall review stages of the audit. It may be applied at other states. It means the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts.

1. Analytical procedures include the consideration of entity's financial information with prior periods anticipated results or the forecasts predicted estimates prepared by the auditor, or similar industry information.
2. It will also include consideration of relationship between elements of financial information, that would be expected to conform to a pattern and also between relevant financial and non-financial information. Various methods can be used for the purpose.
3. The auditor should apply this at planning stage to understand the business and potential.

1.3.15 SAP-15 Audit Sampling (AAS-I5) :

The purpose of the standard is to establish standards on the design and selection of 'audit sample' and evaluation of the sample results.

1. While using statistical or non statistical sampling methods, the auditor should design and select audit sample.
2. Audit sampling means the application of the audit procedures to less than 100% of the items to form an opinion about the population.
3. While designing the audit sample, the auditor should consider specific objectives. He should decide the population from which to draw sample. The individual items that make up the population are known as sampling unit.
4. For effective and efficient designing sample stratification may be used. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling unit which has similar characteristics.
5. When determining the sample size, the auditor should consider sampling risk, the tolerable error and the expected error.
6. Sampling risk is the conclusion drawn on the basis of sample is likely to be different from if drawn on the basis .of population. Sample size is influenced by the extent of sample

1.3.16 SAP-16 Going Concern (AAS-16) :

The purpose of the standard is to establish standards on the auditor's responsibility in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements. While doing audit the auditor should consider appropriateness of going concern assumption the auditor's report helps establish the credibility of the financial statements. However, it is not a guarantee as to the future viability of the entity.

1. An entity's continuance as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the

preparation of financial statements in the absence of the information to the contrary.

2. The auditor should consider the risk that the going concern assumption may not be appropriate. He should consider the financial indications, operating indicators and other indications for the purpose.
3. During the course of the audit he carries out the audit procedures designed to obtain audit evidence as the basis for expression of an opinion. Regarding this assumption additional procedure may be carried out to satisfy the requirement.

1.3.17 SAP-18 Quality Control for Audit Work (AAS-17) :

The purpose of the standard is to establish standards on the quality control :

(a) Policies and procedures of an audit regarding audit work generally; and
(b) Procedures regarding the work delegated to assistants on an individual audit Quality control policies should be implemented at both the level of the audit firm and on individual audit. .

The audit firm should important quality control policies and procedures designed to ensure that all audits are conducted according to the standard.

1. The objectives of the quality control policies to be adopted b an audit firm will incorporate following: professional requirements, skill and competence, assignment delegation, consultation, acceptance and retention of clients and monitoring, etc.
2. The firms polices regarding quality control shall be well understood by the personnel of the firm.
3. The auditor should implement those quality control proceed are in the content of the policies and procedures of the firm, appropriate to be individual audit.

1.3.18 SAP-18 Audit of Accounting Estimates (AAS-18) :

The purpose of he standard is to establish standards on the audit of accounting estimates contained in financial statements.

1. The auditor would review the continuing appropriateness of formulae used by the management in the preparation of accounting estimates.
2. In the case of complex estimating processes involving specialized techniques it may be necessary to use the services of experts.
3. the auditor would test the calculation procedures used by management
4. To test the reliability of estimates he should compare the estimates of the pasts with the actual pf the same period.
5. Material accounting estimates and procedures are or manly reviewed and approved by the management.
6. The auditor may make independent estimates and compare them with the estimates prepared by the. Management

7. The transactions and events which occur after period end, but prior to completion of the audit may provide audit evidence regarding an accounting estimate provided by the management.
8. The auditor should make a final assessment about the reliability of the estimates before using them.
9. Because of the uncertainties inherent in accounting estimate evaluating differences can be more difficult than in other areas of audit

1.3.19 SAP-19 Subsequent Events (AAS-19) :

The purpose of the standard is to establish standards on the auditor's responsibility regarding subsequent events. Subsequent events refer to the events happening between the balance sheet date and auditor's report.

1. The auditor should consider the effect of subsequent events on the financial statements and on the auditors report.
2. The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosures in the financial statements have been identified.
3. These procedures should be performed as near to the date of auditor's report as may be possible.
4. When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events, that the auditor believes should be accounted, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

1.3.20 SAP-20 Knowledge of the Business (AAS-20) :

The purpose of this standard is to establish standards on what is the knowledge of the business, why is it important to the auditor and to the members of audit staff, why it relevant to all phases of an audit, and how. The auditor obtains or uses that knowledge.

1. In performing an audit of financial statements, the auditor should have or obtain knowledge the business sufficient to enable the auditor to identify and understated the events, the transactions and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination of the audit report.
2. The auditor's level of knowledge for an engagement would include a general knowledge of the economy and industry within which the entity operates.
3. Prior to accepting the engagement, the auditor would obtain a preliminary knowledge about the industry and consider whatever adequate knowledge to perform the audit could be obtained.

4. Following acceptance of the engagement more information and knowledge will be obtained.
5. Obtaining the knowledge is a continuous process.
6. Knowledge of the business is a frame of reference within which the auditor exercises professional judgement. The auditor makes judgment about many matters throughout the course of audit, where knowledge of the business is important.
7. The auditor should ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them.
8. To make effective use of the knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor's knowledge of the business.

1.3.21 SAP-21 Consideration of Laws and Regulations in an Audit of Financial Statements (AAS-21) :

The purpose of this standard is to establish standards on auditor's responsibilities regarding consideration of laws and regulations in an audit of financial statements.

1. When planning and performing audit procedures and in evaluating and reporting the results I thereof, the auditor should recognize that non-compliance by the entity with laws and regulations, may materially affect the financial statements.
2. Laws and regulations vary considerably in their relation to the financial statements.
3. It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations.
4. The auditor is not and cannot be held responsible for non- compliance.
5. The risk that the non-compliance may not be detected is higher than normal unavoidable risk.
6. The auditor should plan and perform audit recognizing that the audit may reveal conditions or events that would be questioning whether an entity is complying with laws and regular

1.3.22 SAP-22 Initial Engagements-Opening Balances (AAS-22) :

The purpose of these standards is to establish standards regarding audit of opening balances in case of initial engagements i.e. when the financial statements are audited for the first time.

1. Opening balances means those account balances which exist at the beginning of the period.
2. For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) The closing balance & of the preceding period have been correctly brought forward to the current period;

(b) The opening balances do not contain misstatements that materially affect the financial statements for the current period; and

(c) Appropriate accounting policies are consistently applied.

3. For the purpose of this standard he needs to know the accounting policies, the contents of auditor's report, the nature of opening balances and their materiality.

4. Where he is not satisfied, he may give qualified opinion or disclaimer

1.3.23 SAP-23 Related Parties (ASS-23) :

The purpose of to standard is to establish standards on the auditor's responsibilities and audit procedures regarding related parties and transactions with related parties.

1. The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements.

2. Management is responsible for the identification and disclosure of related parties and transactions with them. Parties are considered to be related, if at any time during the reporting period one party has the absolute control over other party or exercise significant influence over the other party on making financial and operating decision.

1.3.24 SAP-24 Audit Considerations to Entities Using Service Organisations (AAS-24) :

The purpose of this standard is to establish standards for the auditor whose client uses a service organisation.

1. The auditor should consider how a service organisation affects the clients' accounting and internal control systems so as to plan the audit and develop an effective audit approach.

2. While planning the audit, the auditor of the client should determine the significance of i.e. activities after the service organisation to the client and their relevance to the audit.

3. If the auditor of the client concludes that the activities of the service organisation and significant to the entity and relevant to the audit, the auditor should obtain sufficient information to understand the accounting and internal control systems of the service organisation' to assess control of risk at either the maximum, or a lower level if tests of control are performed.

4. When the auditor of the client uses the report of a service organization's auditor, the auditor of the client should consider the professional competence of other auditor in the context of specific assignment, if the other auditor is not a member of the Institute of Chartered Accountants of India.

1.3.25 SAP-25 Comparatives (AAS-25) :

The purpose of this standard is to establish standards on the auditor's responsibilities regarding comparatives. It does not deal with the situations when summarized financial statements are presented with the audited financial statements.

1. The auditor should, determine whether comparatives comply, in all material respects, with the financial reporting framework relevant to the financial statements being audited.
2. The existence of differences in financial reporting frameworks results in comparative financial information being presented differently. Comparatives in financial statements, for example, may present amounts (such as financial position, results of operations and cash flows) and appropriate disclosers of an entity for more than one period, depending on the framework.
3. The auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting frame work.

1.3.26 SAP-26 Terms of Audit Engagement (AAS-26) :

The purpose of the standard is to establish standards on:

(a) Agreeing the terms of engagement with the client; and

(b) The auditor's response to a request by a client to change the terms of the engagement to one hat provides lower levels of assurance.

1. The auditor and the client should agree on the terms of engagement, which should be recorded in an engagement letter or other suitable form of contract.
2. in the interest of both client and auditor, the auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstanding with respect to the engagement.
3. The letter of engagement should cover objectives of audit, management responsibility the statements, management's responsibility for consistently following accounting principles and policies maintenance of records, the scope 'of audit, unrestricted access to records etc.
4. it may also include arrangements regarding planning of audit, basis of billing and determination of fee etc.
5. on recurring audits, the auditor should consider whether circumstatl1ces require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of engagement.

1.3.27 SAP-27 Communication of Audit Matters with those Charged with Governance (AAS-27) :

The purpose of this standard is to establish standards on communication of audit matters arising from the audit of financial statements between the auditors and those charged with the governance of an entity.

1. The auditor should communicate audit matters of governance interests arising from title audit of financial statement with those charged with governance of an entity.
2. The auditor should determine the relevant persons who are charged with governance and with whom audit matters of governance interest are to be communicated.
3. The auditor should consider audit matters of governance interest that arise from the audit of financial statements and communicate them with those changed with governance.
4. The auditor should communicate audit matters of governance interest on a timely basis.
5. The communication may be made orally or in writing

1.3.28 SAP-28 Auditor's Report on Financial Statements (AAS-28) :

The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the form and content of the auditor's report issued as a result of an audit performed by an auditor of the financial statements of an entity. Much' of the standards laid down by this AAS can be adapted to auditor's reports on financial information other than financial statements.

1. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.
2. The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole.
3. The auditor's report should have an appropriate title.
4. The auditor's report should be appropriately addressed as required by the circumstances f the engagement and applicable laws and regulations.
5. The auditor's report should identify the financial statements of the entity that have been audited, including the date of and period covered by the financial statements.
6. The auditor's report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.
7. The report should include a statement that the audit was planned and performed to obtain reasonable assurance whether the financial statements are free of material misstatement.
8. The auditor's report should describe the audit as including :
   (a) Examining, on a test basis, evidence to support the amounts and disclosures in financial statements;

(b) Assessing the accounting principles used in the preparation of the financial statements;

(c) Assessing the significant estimates made by, management in the preparation of the financial statements; and

(d) Evaluating the overall financial statement presentation.

1.3.29 SAP-29 Auditing in a Computer Information System Environment (AAS-29) :

The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on procedures to be followed when an audit is conducted in computer information systems: (CIS) environment. For the purposes of this AAS, a CIS environment exist~ when one or more computer(s) of any type or size is (are) involved in the ,processing of financial information, including quantitative data, of significance to the audit, whether those computers are operated by the entity or by a third party.

1. The auditor should consider the effect of CIS environment on the audit.
2. The auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the CIS environment. The auditor should consider whether any specialise CIS skills are needed in the conduct of the audit.
3. If specialized skills are f1eeded, the auditor would seek the assistance of an expert possessing such skills, who may either be the auditor's staff or an outside professional If the use of such a professional is planned, the auditor should, in accordance with AAS 9, "Using the Work of an Expert", obtain sufficient appropriate audit evidence that the work performed by the expert is adequate for the purposes of the audit.
4. In accordance with the Auditing and Assurance Standard (AAS) 6, "Risk Assessments and Internal Control", the auditor should obtain and understanding of the a counting and internal control systems sufficient to plan the audit and t determine the nature, timing and extent of the audit procedures. Such an understanding would help the auditor to develop an effective audit approach.
5. In planning the portions of the audit which may be affected by the CIS environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of the data for use in the audit.
6. When the computer information systems are significant, the auditor should also obtain understanding of the CIS environment and whether it may influence the assessment of inherent and control risks.
7. The auditor should ma e as assessment of inherent and control risks for I

material financial statement assertions, in accordance with AAS-6 (Revised) "Risk Assessments and Internal control".

1.3.30 SAP-30 External Confirmations (AAS-30) :

The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on the auditor's use of external confirmations as a means of obtaining audit evidence.

1. The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statements assertions. The auditor should employ external confirmation procedures in consultation with the management.
2. The auditor should assess whether the evidence provided by the confirmations reduces audit risks for the related assertions to an acceptably low level. In making that assessment, the auditor should consider the materiality of the account balance and the auditor's assessment of the inherent and control risk. If the auditor concludes that the evidence provided by the confirmations alone is not sufficient, he should perform additional procedures.
3. The auditor should design external confirmation requests to the specific audit objective.
4. The auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited.
5. When the auditor i seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. The auditor should also ask the management to submit its request in a written form, detailing therein the reasons for such request.
6. If the auditor agree to management's request not to seek external confirmation regard g a particular matter, the auditor should document the reason for acceding to the management's request and should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.
7. If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report. The auditor should, however, in this case also,

document the request made by the management along with the reasons given by the management therefore as well as his own reasons for not acceding to the management's request.

1.3.31 SAP-31 Engagements to Compile Financial Information (AAS-31) :

The purpose of this Auditing and Assurance Standard (AAS) is to establish standards on professional responsibilities of an accounting when an engagement to compile financial statements or other financial information is undertaken and the form and content of the report to be issued in connection with such a compilation so that the association of the name of the accountant with such financial statements or financial information is not misconstrued by a user of those statements or information as having been audited by him.

1. The objective of a compilation engagement is for an accountant to use accounting expertise as opposed to auditing expertise, to collect, classify and summarise financial information.
2. The accountant should comply with the Code of Ethics' issued by Institute of Chartered Accountants of India.
3. Where the accountant is not independent, a statement to that effect should be made in the accountant's' report.
4. In all circumstances when an accountant's name is associated with financial information compiled' by him, the accountant should issue a report.
5. The accountant should, accordingly, obtain an acknowledgement from the management of its responsibility for the appropriate preparation and presentation of the financial statements or other information and of its approval of such information to be compiled. The accountant should also obtain an acknowledgement from management of its responsibility for the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information to the accountant.
6. The accountant should, ensure that there is a clear understanding between the client and the accountant regarding the terms of the engagement by means of an engagement letter or such other suitable form of contract. Thus, it is in the interest of both the accountant and the entity that the accountant sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the accountant's acceptance of the engagement and helps avoid misunderstanding regarding matters such as the objective and scope of the engagement and the extent of the auditor's responsibilities.
7. The accountant should plan the work so that an effective engagement will be performed.

1.3.32 SAP-32 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information (AAS 32) :

The purpose of this AAS is to establish and provide guidance on the auditor's professional responsibilities. When an engagement to perform agreed Upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement :

1. 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.
2. The auditor shuld comply with the Code of Ethics, issued by the Institute of Chartered Accountants of India.
3. Where the auditor is not independent, a statement to that effect should be made in the report of factual findings.
4. The auditor should conduct an agreed-upon procedure engagement in accordance with this AAS and the terms of the engagement.
5. The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.
6. The Auditor should plan the work so that an effective engagement will be performed.
7. The auditor should document matters which are important in providing evidence to Support the report of factual findings, and evidence that the engagement was carried out in accordance with this AAS and the terms of the engagement.
8. The report of factual findings should contain :

(a) Title;

(b) Addressee (ordinarily, the appointing authority);

(c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;

(d) A statement that the procedures. performed were those agreed-upon with the recipient;

(e) A statement that the engagement was performed in accordance with the auditing and Assurance Standard applicable to agreed upon procedures engagements;

(f) Identification of the purpose for which the agreed-upon procedures were performed;

(g) A listing of the specific procedures performed;

(h) A description of the auditor's factual findings including sufficient details of errors and exceptions found;

(i) A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expression;

(j) A statement that had the auditor performed additional procedures, an auditor a review, other matters might have come to light that would have been reported;

(k) A statement that the report is restricted to those parties that have agreed to the procedures to be performed;

(l) A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;

(m) Date of the report;

(n) Place of signature; and

(o) Auditor's signature: The report should be signed by the accountant in his personal name where the firm is appointed, the report should be signed in the personal name of the accountant and in the name of the firm. The partner/ proprietor signing the report on agreed-upon procedures should also mention the membership number assigned by the Institute of Chartered Accountants of India.

1.3.32.1. Self check exercise-2

1. explain AAS 30

1.3.33 Summary :

This lesson gives the detailed knowledge about the statements on standard auditing practices (SAPs). This is applicable whenever an independent audit is carried out. While discharging their attest functions; it will be the duty of members of the Institute to ensure that SAPs are followed in the audit of financial information covered by their audit reports. This include various standards like basic principles, objectives, scope, auditors responsibility regarding frauds and errors, going concern, related parties audit, terms of audit engagements, engagements to Perform Agreed-Upon Procedures Regarding Financial Information etc.

1.3.34 Glossary :

(i) ASB: Accounting standards Board,

(ii) APC: Auditing Practices Committee.

(iii) AASB: Auditing and Assurance Standards Board.

(iv) SAPs: Standard Auditing Practices.

(v) AAS: Auditing and Assurance Standards.

1.3.35 Questions :

1. Give an introduction to 'Auditing and Assurance' standards. Discuss AAS-l.
2. Discuss AAS concerning 'auditor's responsibility to consider fraud and error in an audit of financial statements'.
3. Discuss AAS concerning risk assessment and internal control.
4. Discuss introduction to any two 'Auditing and Assurance Standards.'
5. Write short note on:

   AAS- 5

   AAS- 7

   AAS- 14

1.3.36 Suggested Readings :

(i) Contemporary Auditing - Kamal Gupta.

(ii) Auditing theory and practice- Pardeep Kumar,Baldev Sachdeva, Jagwant

Singh.

LESSON NO. 1.4

INTERNAL CONTROL AND INTERNAL CHECK

1.4.1 Objectives of the Lesson

To study Meaning of internal Control, Objectives of Internal Control, Meaning of Internal Check, Objectives of Internal Check, General aspects of Internal check system.

To discuss Advantages and Dis-advantages of Internal Check, Internal Check and Auditor, Structure/Scope of Internal Check :

To explain Internal Check regarding Cash, Purchases, Purchases return, Credit Sales, Sales Return, Stores and Wages.

1.4.2 Introduction :

In order to carry on business in an orderly manner, to safe guard the assets and secure the accuracy and reliability of its records, certain systems of control are established by the management. "Internal Control is best regarded as indicating the whole system of controls, financial and otherwise, established by the management in the conduct of a business, including internal check, internal Audit and other forms of control." Internal control system is employed by the business for the purpose of :

(1) Promoting accuracy and reliability in accounting and operating data.

(2) Safe guarding its resources against waste, fraud and inefficiency.

(3) Encouraging company's policies; and

(4) Judging the efficiency of operations in all divisions of business.

Internal control is a wide term and includes a number of checks and controls exercised in a business to ensure its efficient working.

1.4.3 Objectives of Internal Control

The objectives of internal control are as follows :

1. Internal control is used to avoid waste, inefficiency and fraud to keep intact it's resources.
2. Internal control is used to evaluate efficiency of business performance.
3. Internal control is used to attain accuracy, and reliability of information revealed by accounts.

Internal control means not only internal check and internal audit but the whole system of control, financial and 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 records. Financial controls, include budgetary; control, cash control etc. Non-financial controls are employed to prevent errors and frauds, such as adoption of a perpetual inventory system, installation of time recording clocks to properly and accurately record time of the workers, use of machines for affixing postage stamps etc.

1.4.4 Elements of Internal Control

An effective system of internal control should have the following characteristics:

1. Competent and trustworthy personnel

Personnel is a vital element of any system of internal control. If employees are competent and honest, some of the other requirements can be absent and reliable financial statements can still result.

2. Records, financial and other organisational plans

Documents act as the source of transmitting information throughout the clients' organisations and between different organisations. The documents must be adequate to provide reasonable assurance that all assets are properly controlled and all transactions correctly recorded.

3. Segregation of duties

For prevention of both intentional and unintentional errors, it is essential that :

(i) **Separation of operational responsibility from record keeping responsibility :** To ensure unbiased information record keeping should be included as a separate department under the control function.

(ii) **Separation of the custody of assets from accounting :** Custody of assets and their accounting should be done by separate persons to protect the firm against frauds.

4. Supervision

The company's financial operations and position at regular intervals, comparisons with results for previous periods indicate discrepancies that call for further examination.

5. Authorisation

Every transaction must be properly authorised, the individual or group which can grant either specific or general authority for transactions should hold a position commensurate with the nature and significance of the transactions and the policy for such authority should be established by top managements.

6. Sound Practices

Procedures and policies with regard to delegation of responsibility should not divert any one. The responsibilities should be sound and written.

7. Internal Audit

Internal audit should operate independently of the internal check and should not divert any one of the responsibilities placed on him.

8. Arithmetic and Accounting Controls

Chart of accounts i.e. balance-sheet and income statement is an important control as it provides the frame work for determining the information presented to management and other financial statement users.

1.4.5 INTERNAL CHECK

Internal check is a part of the overall control system and operates as an inbuilt-device so far as the staff organisation and job allocation aspects of the control system are concerned. A system of internal check in accounting implies, organisation of the system of book keeping and arrangements of staff duties in such a manner that no one person can carry through a transaction and record every aspect thereof.

According to Spicer and Peeler, "A system of internal check is the management of staff duties where by no one person is allowed to carry through to record every aspect of a transaction so that, without collusion between two or more persons, fraud is prevented, at the same time, the possibilities of errors reduced to a minimum."

According to Dixie L.R., "Internal check may be defined as such a management of the accounting routine, the errors and frauds are automatically prevented as discovered by the very operation of the keeping itself."

From the above, the essential elements of a system of internal check are :-

(a) Existence of checks on the day-to-day transactions.

(b) Operate continuously as a part of the routine system.

(c) The work of each person is either proved independently or is made complementary to the work of another.

1.4.5.1 Objectives of Internal Check

Internal check system, in an organisation, serves the following purposes :-Its main objective is to prevent, and to bring about a speedy detection of frauds, wastes and errors,

(i) Another objective is to make division of work and fixing responsibility individually,

(ii) To prevent the errors of omissions regarding important agreements of business,

(iii) To prevent errors and frauds committed by accounting staff knowingly,

(iv) To increase the efficiency of employees.

(v) To prepare the final accounts quickly, the internal check is very useful.

1.4.5.2 General Aspects of an Internal Check System.

The following considerations should be kept in mind in framing a system of internal check :-

(1) No single person should have an independent control over any important aspect of the business.

(2) The duties of members of the staff should be changed from time to time without any previous notice.

(3) Physical custody of assets must not be permitted to any employee.

(4) To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.

(5) Existence of accounting control in respect of each important class of assets is necessary; in addition, these should be periodically inspected to find out their physical condition.

(6) A majority of business concerns now-a-days work according to some kind of budgetary control. It enables them a review, from time to time of the progress of their trading activities. If wide discrepancies are observed, these should be reconciled.

(7) For stock taking at the end of the year, trading activities should, if possible, be suspended.

(8) Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

1.4.5.3 Advantages of Internal Check

There are various advantages of Internal Check system which are as follows :-

1. Completing the work with responsibility is its main advantage.
2. Another advantage is to minimise frauds and mistakes in the accounting books made by the staff.
3. Speedy work is done through this system.

4. Internal check also facilitates the work of external auditor.
5. It also leaves a moral and psychological effect on employees of a business.
6. Final accounts are also prepared in lesser time and less hard work.
7. It also increases the working efficiency of employees.

Disadvantages of Internal Check

There are some disadvantages from this system, which are :

(i) It is an expensive system of checking because it needs more employees and documents,

(ii) This type of checking also creates bad effect on employees,

(iii) It increases the possibility of errors and frauds because under this checking proprietor does not care for his accounting books.

(iv) There is delegation of work because the work of one person is independently checked by another person.

(v) Under this system auditors also become careless.

(vi) Internal check creates trade unionism in employees.

1.4.5.4 Self-check exercise 1

1. What is internal control?

1.4.6 Internal Check and Auditor

An important question arises as to what extent an auditor should rely on the internal check system. The extent to which an auditor can depend upon the system of internal check should be based on the procedural tests applied by him to find out the effectiveness of the internal check system. He should examine the system in the light of the size and nature of the business to ensure how far the system of internal check is in operation. An efficient system of internal check can make auditor's work easy and convenient. But the existence of the system of internal check does not reduce the liabilities of an auditor. He will be held guilty of negligence regardless of the fact that he had tested the internal check in operation before he had accepted it as correct. He cannot be relieved of his liability on the ground that since the system of internal check was good, he did not perform a particular function. Inter relationship of internal control, internal check and internal audit.

I. Internal control and Internal Check

(i) Scope Internal Control comprises the whole system of controls, financial or otherwise established by the management for the conduct of business. It includes internal check and internal audit besides other controls. But internal check refers to a system of allocating duties among the staff is such a manner that every person records a different aspect of a transaction. It is narrower in scope.

(ii) Objects : A system of internal control strives to achieve objectives such as adherence to policies and procedures laid down by management, safeguarding of assets, prevention and detection of errors and frauds, accuracy and completeness of records and timely preparation of reliable financial information. On the other hand, internal check system is designed to prevent errors and frauds and fixing responsibility and safeguarding assets. It is a part of internal control system.

(iii) Flexibility - Internal control system is reviewed occasionally by the management in the light of changes within the organisation, in the economic environment and suggestions of internal auditor and external auditors. But internal check once introduced in the business is generally stable for a certain period and hence, less flexible as compared to internal control system.

Internal Audit and Internal Check

(i) Meaning : Internal audit is an independent review of operations and records.While internal check is an arrangement of duties allocated in such a manner that the work of one done is automatically checked by another.

(ii) Staffing requirement : Internal audit is carried out by staff especially assigned for it. For internal check, no special staff is required to be engaged.

(iii) Timing : Internal audit is a postmortem analysis and starts after the completion of recording of transactions. But internal check is simultaneous i.e. starts operating the moment a transaction is finalised and continues till all its aspects are recorded.

(iv) Object : The object of internal audit is to detect frauds and error. But the object of internal check is to prevent frauds and errors.

(v) Submission of report : Internal auditor submits his report to the management. While under the system of internal check, the statement relating to the transactions for the whole day is to be submitted by clerk to departmental heads.

1.4.7 STRUCTURE/ SCOPE OF INTERNAL CHECK

In an organised business there is need for a good internal check system for different types of receipts and payments. It can be explained in the following manner:

1. Internal Check as Regards Cash

Every cash transaction is written in cash book. To check the internal procedure of this book, the following rules should be kept in mind:

(i) There must be a proper control over cash receipts and payments.

(ii) The employees relating to cash book should be kept intact from other accounting staff.

(iii) The allocation of duties and responsibilities should be in such a way that every clerk, may be held responsible for a particular error or fraud.

(iv) There must be use of register because it reduces the possibilities of frauds.

(v) Bank reconciliation statement must be prepared from time to time.

All cash transactions can be divided into two parts i.e.

(a) Cash receipts (b) Cash Payments. Now, the detailed study of these two sides is as follows:

(a) Internal Check and Receipt Side :

The following controls should be instituted over receipt side :

1. Cheques, drafts, postal orders etc., should be received and opened by the responsible person. A check list showing receipts of money orders and cheques may be prepared as the mail is opened.
2. All remittances should be crossed immediately by means of a rubber stamp as "Not negotiable -A/C payee only."
3. Custody and control of money received should be the responsibility of independent person.
4. Cash receipts should be independently reconciled with sale records.
5. All receipts should be banked daily, and reconciliation of transaction from time to time is necessary.
6. The cashier should not have the control over books of account, securities, negotiable instruments, sale invoices and credit notes etc.
7. The pay-in-slips should be filled up by an independent person.
8. Independent surprise counts of cash balances should be carried out periodically.
9. The debtors or institutions from whom cash is received should be advised to collect proper receipts from the head office.

Internal Checks of Cash Sales

Cash sale can be made with three types :

1. Sales at the counter.
2. Sales by travelling Agent.
3 Postal Sales.

In big business concerns, there are chances of fraud. So, there must be check on the above type of sale in the following manner:

1. Sales at the Counter

The following procedure may be of great use in regard to cash sales :

(i) A specific number of work may be allotted to every salesman to know the sales made by every salesman.

(ii) Every salesman should be given a separate book in different colours containing blank copies of cash memo.

(iii) The three copies of cash memo should be prepared and checked by another official, and then signed by the salesman.

(iv) Two copies should be handed over to customer and instructed to pay cash to the cashier.

(v) After getting cash, the cashier hands over the goods and a copy of the cash memo duly stamped as Cash paid. This is a daily routine. At the end of the day, the salesman and the cashier prepare summaries and send them to the General Manager.

2. Sales by Travelling Agents

A good system of Control over these agents may be like this :

(i) The travelling agents should be authorised to issue rough receipts to the customers for cash received and customers should be instructed to acquire receipts from Head Office.

(ii) If the customers do not receive information properly from head office, they should make correspondence to the Head Office directly.

(iii) Agents should be instructed to remit whole cash to the Head Office,

(iv) The Head Office should send the list of debtors to agents.

(v) Agent will send the names of defaulters and will intimate to the Head Office.

(vi) These agents should be shifted over to other places to increase their office.

(vii) These agents should be shifted to other places to increase their efficiency and avoiding fraud.

3. Postal Sales

(i) Separate register is necessary to record sales made by post.

(ii) The goods returned should be entered in V.P.P. Register.

(iii) Receipts of cash from customers should be entered in V.P.P. Register.

(iv) Reconciliation of postal orders and cash book is necessary from time to time.

(v) A responsible person should be appointed to check carefully the Register.

(b) Internal Check of the payment Side of Cash Book

(i) An independent person for cash payments is necessary for a good system of internal audit.

(ii) Petty cash payments should be made by the petty cashier.

(iii) All payments should be made through cheques with some exceptions where only cash is needed.

(iv) The issue of cheques should be properly controlled and authorities for signing cheques should be clearly defined.

(v) Normally, cheques should be issued only after they have been restrictively crossed.

(vi) Strict regulations should be in force to sanction payment of special nature.

(vii) Confirmation of accounts with the creditors should be made through direct correspondence.

(II) Purchases and Internal Checks

Every business has a separate department for purchases. The efficiency of such a department depends upon its policy of purchasing better goods at less price. The whole process of purchases may be divided into two following parts :

(i) Estimating the needs of organization by receiving requirements from different departments.

(ii) Inviting tenders and quotation from different traders regarding prices and quality and other enquiries of goods.

(iii) Then placing the order according to the requirement of different departments.

(iv) After placing the order, the goods are received and counted and checked to see that these goods are as per the order and quality,

(v) Checking and verifying the bill and preparing the documents for payments,

(vi) Payment of bills and recording in the books of accounts.

(III) Internal Checks Regarding Purchases Return

(i) Proper system of control regarding purchases return is necessary,

(ii) A statement should be prepared by the stores department for all goods returned,

(iii) The accounts department should examine the invoice note prepared by purchases department with original invoice and enter it in Purchases Returns Book,

(iv) A credit note should be obtained from the supplier.

(IV) Internal Check Regarding Credit Sales

The system of credit sales should be kept under proper control. A separate department for sales should be made. The Department of sales should have the charge of receiving orders, supplying goods, preparing invoices and maintaining accounts of goods supplied. The procedure of this department may be as follows :-

(i) Orders Received Book should be kept to write all orders received and numbers of the orders and its copy should be sent to the despatch department.

(ii) The dispatch department will pack the goods and a list will be prepared in triplicate.

(iii) Then, the list will be sent to the counting house where the list of goods should be checked and rates etc. entered in it and the invoice will be prepared in triplicate,

(iv) Two copies will be sent to customer and one copy will be returned by the customer after signing it when he receives the goods.

(v) Goods supplied on order should be checked with Orders Received Book when it will be recorded in the Goods Outward Book.

(vi) The invoice Book should also be compared with the Goods Outward Book and the Orders Received Book and the Sales Book should be prepared from the invoices.

(V) Internal Check Regarding sales Return

(i) Goods returned by customers should be recorded in Returns Inward Book.

(ii) The statement of goods will be sent to Despatch department, who will send it to Accounts Department after checking these goods.

(iii) Then a credit note will be sent to customer after signing by an officer responsible for that.

(iv) Then Sales Return Book will be prepared from the credit notes issued to customers.

(VI) Internal Check Regarding Stores

The Stores Department has charge of preserving and issuing stores to the different departments. Chances of frauds are more if there is no proper control and internal check system. So, there must be following steps to control the stores :

(i) After receiving the goods, the Stores Department will prepare "Good Receipt Note" in triplicate : One for purchase Department, second for the Accountant and third for the Stores Department itself.

(ii) The Goods should be properly checked after receiving them and should be properly preserved before issuing them.

(iii) Then the goods/stores will be issued through proper procedure i.e. first of all requistion slip from every department is collected and then according to the requirements the goods are issued by storekeeper, and he will write these goods in issuing register and signature of the receiving person is necessary on this register. And if some goods are returned by some departments, a store Return Book should be prepared.

(iv) The recording of stores should be prepared by a separate person.

(v) If the Bin Cards are used to record stores then these should be checked and compared from time to time with stores record cards.

(VII) Wages and Internal Check

In a big organisation where the number of workers is very large, there should be an important work of keeping records and payments regarding wages. In this case accountant should also be alert.

Objectives of Internal Check Regarding Wages

There are some objectives regarding internal check of wages which are as follows :-

(i) Knowledge of attendance is necessary.

(ii) Proper payment of wages.

(iii) Check on wrong payments.

(iv) Check of wage reports.

(v) Proper record of deductions is necessary,

(vi) Proper wages of proper workers.

Procedure of Internal Check of Wages

To achieve above objectives the following steps for internal check may be used:-

1. Appointment of workers should be made by a separate personnel department. The record of every worker should be recorded in a register.
2. Accounting of wages may be made through two aspects :
   (a) Time Wages (b) Piece Wages.

(a) **Record with Time Wages** should be made by an independent person. The recording of time may be made through following techniques :

(i) Time recording clock may be used.
(ii) Token may be used.
(iii) Use of attendance cards.
(iv) Recording of overtime work may be used.
(v) Accounting of leaving organisation-at the time of work.

(b) **Accounting of wages through piece wage system :** The following methods may be applied

(i) Job cards should be prepared where the wages are paid through work and not according to time.
(ii) A card for waste time may be prepared.
(iii) Accounting of cards is necessary to be done by Accounts Department,
(iv) One register should be made for all accounts.

Preparation of Wage sheets

Wage sheet should normally be divided into four parts :

(a) Two clerks should be appointed to examine the time and piece wage record, overtime records, statements received from the foreman etc.
(b) Third clerk should be to examine the names and addresses of workers, rates, attendance, gross amount of wages etc.
(c) Fourth clerk should be to examine the work already done.
(d) Fifth clerk to check the whole work thoroughly.
(e) All these clerks perform their jobs and sign the sheets which are certified by some responsible officer such as Director, Manager, etc.
(f) Such wage sheets can be prepared for both type of wages i e. time as well as piece wages.

Payment of Wages

The wage sheets should be passed over to the Cashier who has not be associated with their preparation. The Cashier will withdraw the cash as required by wage sheets, then the payment can be made through following methods :

(i) No clerk should be present at the time of disbursement of wages who prepared the wage sheets.
(ii) Pay packets may be used for payment of wages.
(iii) All workers should be present at the time of payment of wages.

(iv) To prevent proxy, the foreman of every department should be present.

(v) The payment to casual workers should be written in separate list and payment should be made in the presence of a responsible person.

1.4.7.1. Self check exercise-2.

1. What is internal check? What is its scope?

1.4.8 SUMMARY

Internal control is an integral part of control exercised by every organisation. Internal check is a form of internal control through which every organisation exercises the whole system of controls, financial and otherwise established by the management in the conduct of a business.

1.4.9. Glossary

A/C- Account Payee

1.4.10. Questions for Exercise

1. Distinguish between Internal check and Internal audit.
2. Distinguish between Internal check and Internal Control.
3. What are the arms of internal control so far as financial aspects are concerned?
4. Write short note on:

   Internal control.

   Internal check.

   Objectives of internal control.

1.4.11. SUGGESTED READINGS

Practical Auditing	:	B.N. Tandon
Auditing Theory and Practice	:	Pardeep Kumar, N.K. Sahni and Baldev Sachdeva.

LESSON NO. 1.5

INTERNAL AUDIT

1.5.1 Objectives of the lesson :

* To study the characteristics of Internal Audit.
* To discuss the scope of Internal Auditing.
* To highlight the difference between Internal Audit and Statutory Audit.

1.5.2 Introduction

Internal Audit is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. Internal Audit is an important tool of the management. It may be described as an independent appraisal of activity within an organisation for the review of the accounting, financial and other business practices as a protective and constructive arm of management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of controls. But internal audit must not be confused with internal check. Internal check consists only of a set of rules of procedure that are part of the accounting system, introduced so as to ensure that accounts of a business shall be correctly maintained and the possibility of occurrence of frauds and errors eliminated. On the other hand, internal audit is a thorough examination of the accounting transactions as well as that of the system according to which these have been recorded, with a view to reassuring the management that the accounts are being properly maintained. and the system contains adequate safe guards to check any leakage of revenue or misappropriation of property or assets and the operations have been properly maintained. The process of Internal Audit is the same as followed for a professional audit. But internal audit often differs in its scope and emphasis. It is more managerial than accounting; also its form is varied, on considering the size of the organisation. For instance, a professional auditor is concerned with the legality and validity of transactions entered into by a business, as the internal auditor is expected to, ensure that the standards of economy and efficiency are being maintained. On this basis, the internal auditor must ascertain that orders for the purchase of stocks are placed only after inviting tenders. Sales, are effected at the highest ruling rates, standard procedure as regards recruitment of staff is followed, losses in the manufacturing process suffered during the period under review are not higher than those in the earlier periods and so on. He must further confirm that there has been no leakage of revenue, over payment of expenditure or pilferage or misappropriation of stocks of any other asset, on checking accounts, reconciling the physical accounting records and physical balances. The nature and extent of checking that he should carry out would also depend on the size and type of the business organisation.

1.5.4 Scope of Internal Auditing :

The institute of Internal Auditors defines the scope of internal auditing as, “the examination and evaluation of the adequacy and effectiveness of an organisation’s system of the internal control and the quality of performance in carrying out assigned responsibilities.” Thus, internal auditing is concerned with an evaluation of both internal controls as well as the quality of actual performance. Thus, according to the Institute of Internal Auditors, the following areas of operations are involved:

1. Internal auditor should review the system established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant impact on operations and report.
2. The internal Auditor should make economical and efficient use of resource.
3. Internal Auditor should review the reliability and integrity of financial or operating information.
4. Internal Auditor should review the means of safe-guard of assets.
5. Internal Auditor should review that established objectives and goals are being carried out as planned.

1.5.5 Objectives of Internal Audit

The overall objective of internal auditing is to assist the management in the effective discharge of their responsibilities by furnishing them with objective analysis and appraisals concerning the activities reviewed. The Objectives of internal audit include :

1. To verify the correctness and truthfulness of the financial accounting and statistical records presented to the management.
2. To ensure that the standard accounting practices are followed in the business.
3. To establish that there is a proper authority for every acquisition, retirement and disposal of assets.
4. To guide the accounting staff in maintaining proper financial accounting records.
5. To confirm that liabilities have been incurred only for the legitimate activities of the organisation.
6. To advise the management in matters of finance and control.
7. To analyse and improve the system of internal check in particular to see (i) That it is working (ii) that it is sound; and (iii) that it is economical.
8. To facilitate the prevention and detection of frauds.
9. To examine the protection afforded to assets and the use to which they are put.
10. To make special investigation for the management in the efficient conduct of business.
11. To provide a channel whereby new ideas can be brought to the attention of management.

1.5.5.1 Selfcheck exercise 1

1. What is Internal audit? Discuss its scope.

1.5.6 Independence of Internal Auditor

The nature and scope of operations and the status of an internal auditor differ from organisation to organisation, according to the needs of the different managements. An internal auditor can only be as effective as the management wants him to be. If an internal auditor has to effectively perform his duties, he should be independent of the activities that he audits. It is possible only if he is given the requisite organisational status.

A proper organisational status for the internal auditing department ensures its relative independence so that it can carry out its work freely and objectively and render unbiased judgements. To ensure the proper organisational status, the following steps may be useful :

(i) The top management should give full support to the internal auditors.

(ii) The chief internal auditor should be responsible to an officer of sufficient rank and authority for prompt action on audit reports.

(iii) The functions, responsibilities and authority of the internal auditing department should be clearly defined in written.

(iv) The Chief internal auditor should have direct communication with the top management.

1.5.7 Organizing an Internal Audit Department

The Director of internal auditing should manage the internal auditing department.

1. The Director of internal auditing should have a clear statement of purpose, authority and responsibility for the internal auditing department.
2. The Director should establish plans to carry out the responsibilities of the internal auditing department.
3. The Director of internal auditing should provide written policies and the procedures to guide and audit staff and human resources of the internal auditing department.
4. The director should establish a programme for selecting and developing the human resources of the internal auditing department.
5. The Director of internal audit should coordinate internal and external audit efforts.
6. The Director should establish and maintain a quality assurance programme to evaluate the operations of the internal department.

1.5.8 Role in Internal Control

Internal auditing activity is primarily directed at evaluating internal control. Under the COSO Framework, internal control is broadly defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following core objectives for which all businesses strive:

" Effectiveness and efficiency of operations.

" Reliability of financial and management reporting.

" Compliance with laws and regulations.

" Safeguarding of Assets

Management is responsible for internal control, which comprises five critical components: the control environment; risk assessment; risk focused control activities; information and communication; and monitoring activities. Managers establish policies, processes, and practices in these five components of management control to help the organization achieve the four specific objectives listed above. Internal auditors perform audits to evaluate whether the five components of management control are present and operating effectively, and if not, provide recommendations for improvement.

In the United States, the internal audit function independently tests managements control assertions and reports to the company's audit committee of the board of directors.

1.5.9 Role in Risk Management

Internal auditing professional standards require the function to evaluate the effectiveness of the organization's Risk management activities. Risk management is the process by which an organization identifies, analyzes, responds, gathers information about, and monitors strategic risks that could actually or potentially impact the organization's ability to achieve its mission and objectives.

Under the COSO enterprise risk management (ERM) Framework, an organization's strategy, operations, reporting, and compliance objectives all have associated strategic business risks - the negative outcomes resulting from internal and external events that inhibit the organization's ability to achieve its objectives. Management assesses risk as part of the ordinary course of business activities such as strategic planning, marketing planning, capital planning, budgeting, hedging, incentive payout structure, credit/lending practices, mergers and acquisitions, strategic partnerships, legislative changes, conducting business abroad, etc. Sarbanes-Oxley regulations require extensive risk assessment of financial reporting processes. Corporate legal counsel often prepares comprehensive assessments of the current and potential litigation a company faces. Internal auditors may evaluate each of these activities, or focus on the overarching process used to manage risks entity-wide. For example, internal auditors can advise management regarding the reporting of forward-looking operating measures to the board, to help identify emerging risks; or internal auditors can evaluate and report on whether the board and other stakeholders can have reasonable assurance the organization's management team has implemented an effective enterprise risk management program.

In larger organizations, major strategic initiatives are implemented to achieve objectives and drive changes. As a member of senior management, the chief audit executive (CAE) may participate in status updates on these major initiatives. This places the CAE in the position to report on many of the major risks the organization faces to the audit committee, or ensure management's reporting is effective for that purpose.

The internal audit function may help the organization address its risk of fraud via a fraud risk assessment, using principles of fraud deterrence. Internal auditors may help companies establish and maintain Enterprise Risk Management processes.[9] This process is highly valued by many businesses for establishing and implementing effective management systems and ensuring quality is maintained & professional standards are met[10] Internal auditors also play an important role in helping companies execute a SOX 404 top-down risk assessment. In these latter two areas, internal auditors typically are part of the risk assessment team in an advisory role

1.5.10 Role in Corporate Governance

Internal auditing activity as it relates to corporate governance has in the past been generally informal, accomplished primarily through participation in meetings and discussions with members of the board of directors. According to COSO's ERM framework, governance is the policies, processes and structures used by the organization's leadership to direct activities, achieve objectives, and protect the interests of diverse stakeholder groups in a manner consistent with ethical standards. The internal auditor is often considered one of the "four pillars" of corporate governance, the other pillars being the board of directors, management, and the external auditor.[11]

A primary focus area of internal auditing as it relates to corporate governance is helping the audit committee of the board of directors (or equivalent) perform its responsibilities effectively. This may include reporting critical management control issues, suggesting questions or topics for the audit committee's meeting agendas, and coordinating with the external auditor and management to ensure the committee receives effective information. In recent years, the IIA has advocated more formal evaluation of corporate governance, particularly in the areas of board oversight of enterprise risk, corporate ethics, and fraud.

1.5.11 Audit Project Selection Or "Annual Audit Plan"

Based on the risk assessment of the organization, internal auditors, management and oversight boards determine where to focus internal auditing efforts. This focus or prioritization is part of the annual/ multi-year annual audit plan. The audit plan is typically proposed by the CAE (sometimes with several options or alternatives) for the review and approval of the audit committee or the board of directors. Internal auditing activity is generally conducted as one or more discrete assignments.

It should be adapted to the specific purpose of audit, and the selection of audit method must be adapted to its specific purpose. Otherwise, it will deviate from the purpose of the audit.

1.5.12 Internal Audit and Statutory Audit

According to the detailed study of Internal Audit and Statutory Audit, these are the following points of difference between the two :

1. Internal audit is conducted at the option of management while statutory audit is conducted under law and is legally compulsory in the case of joint stock companies.
2. Internal auditor is appointed by the management whereas the statutory auditor is mostly appointed by the Shareholders.
3. Internal audit is a kind of continuous audit, while a statutory audit may be conducted after the final accounts have been prepared.
4. Remuneration of internal auditor is fixed by the managements while that of the statutory audit is fixed by the shareholders in the general meeting.
5. Internal auditor need not have the qualification as laid down under section 226 of the Companies Act while a statutory auditor must have those qualifications.
6. The primary duty of internal auditor is to detect errors and frauds while in statutory audit, the main purpose is to report whether the Balance Sheet and Profit and Loss Account have been drawn up in the confirmity with and whether they show true and fair view of the state of the affairs of the business. Detection of error and frauds are only secondary duties of a statutory auditor'.

7. Internal audit is conducted by the employees of the business itself while statutory audit is performed by an independent professional auditor.

8. Internal audit serves primarily the needs of management while statutory, audit is conducted to safe guard interest of proprietors and third parties directly.

1.5.13 Difference between 'Internal Check', 'Internal Control' and 'Internal Audit'.

Internal check means the check imposed on the day-to-day transactions, whereby the work of person, is checked independently by another person, the object being the prevention and early detection of errors and fraud and to ensure accuracy. Thus, internal check includes matters such as the allocation of authorities, the division of work and the proper methods of recording transactions etc. It is a part of the overall internal control system and operates as a built-in-device so far as staff organisation and job allocation aspects of control system are concerned. It minimises the possibilities of errors and increases the chances of detection of frauds.

Internal Control comprises the whole system of controls, financial and otherwise, establised by the management in the conduct of the business. It includes internal check, internal audit and various other forms of control. Itis broad term with a wide coverage. The primary objective of internal control is to safeguard the assets of the company against losses, and to aviod fraud, errors, wastes and inefficiency. It enables the management in measuring the implementation of business policies as well as ensuring maximum accuracy of all data and statements.

1.5.13.1 Selfcheck exercise 2

1. How is Internal audit different from statutory audit?

1.5.14 Summary

Internal audit implies a continuous review of the operations and records of a business by internal auditors. The scope and object of internal audit may vary from one business to another and may, particularly in large concerns, extend to many matters which are not directly of an accounting nature. It is conducted to assure management that the system of internal check is effective in design and operations. Internal audit is an integral part of internal control.

1.5.15. Glossary

ERM- Enterprise Resource Management

CAE- Chief Audit Executive

1.5.16. Questions for Exercise :

1. What is internal audit?
2. Distinguish between internal audit and statutory audit.
3. Discuss the role of internal auditor in internal audit.

4. write short notes on :
   objectives of internal control
   statutory audit

1.5.`7 SUGGESTED READINGS

Contemporary Auditing : Kamal Gupta

Auditing Theory & Practice : Pardeep Kumar, N.K. Sahni & Baldev Sachdeva.

B.COM. PART III BCOU3506T

AUDITING

LESSON NO. 1.6

VOUCHING-Defintion; Feauters , Examining vouchers, Vouching of cash book and Vouching of trading transaction

1.6.1 Objectives of the lesson

- To study the concept of vouching
- To understand the verification of various assets and liabilities

1.6.2 Definition :

Vouching, widely recognized as "the backbone of auditing. The act of examining documentary evidence in order to ascertain the accuracy of entries in the account books is called "Vouching". Vouching is a technical term which refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction. Simply stated, vouching means a careful examination of all original evidence 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. Therefore, vouching is the act of testing the truth of entries appearing in the primary books of accounts.

1.6.3 Features :

1. Important aspect of auditing - it is help the auditor in understanding the types of evidence available in collecting it by means of where is audit techniques and in evaluating its adequacy and liability to support accounting entries.
2. Preliminary work of auditing - it should be the first step before doing any other work.
3. It support and substances the transactions – it is to vouching that the auditor can satisfy himself as to accuracy and completeness of the transactions recorded in the books of accounts.
4. Examination of entries - it is merely examination of entries by documentary by other evidences such as vouchers former mint book comma receipts cash book etc.
5. Only business transaction s recorded- in the account of business only recorded business transactions entry.
6. Entries correctness- ensures that there are no material misstatements and

transactions are correct.

1.6.4 Objectives:

Some of the major objectives of vouching are given below:

1. To detect errors and frauds-All transactions are to be supported by evidence. Each document should be proved by authorized authority. With the help of vouching we can detect errors and frauds by verifying each transaction. Planned fraud can be detected through vouching.

2. To know the truth of account-Each and every transaction is checked and ratified on the basis of support document. So, we can easily know the truth of account.

3. To find the unrecorded transactions-Each and every transaction is checked and ratified on the basis of document. Vouching helps to find out the unrecorded or missing transactions. If any voucher is found unrecorded, auditor can suggest recording such transactions.

4. To know that all the transactions are authorized-If the transactions are made on the consent of concerned authority, such transactions are known as authorized transactions. If transactions are not authorized, such transactions can be fictitious transactions. So, such fictitious transactions ca be found with the help of vouching.

5. To know that only the business transactions are recorded-Sometimes, transactions are performed for individual purpose but payment is made out of business. Such transactions should not be recorded in account of business. If such transactions are recorded, we can find it with the help of vouching. To know the real profit or loss of business, such transactions are to be separated.

1.6.5 Importance:

Vouching is the act of checking evidential documents to find out errors and frauds and to know the authenticity, accuracy and reliability of books of accounts. Thus, it is important for an auditor due to the following reasons:

1. Vouching is the backbone of auditing-Main aim of auditing is to detect errors and frauds for proving the true and fairness of results presented by income statement and balance sheet. Vouching is only the way of detecting all sorts of errors and planned frauds. So, it is the backbone of auditing.

2. Vouching is the essence of auditing-Auditing not only checks the accuracy of books of accounts but also checks whether the transactions are related to business or not. All the transactions are performed after the prior approval of concerned authority or not, transactions are real or not because an accountant may include

fictitious transactions to commit frauds. All these facts can be found with the help of vouching. So, vouching is essential for auditing.

3. Vouching is important to see whether evidences are correct or not-An auditor checks the books of accounts to detect errors and frauds. Frauds may be committed presenting duplicate vouchers. All the small and big amounts of frauds can be detected with the help of vouching. So, all the evidential documents and records are to be checked carefully and in detail by an auditor which is the scope of vouching.

2. Examination of Vouchers

While vouching the transactions, the auditor should first of all examine the various vouchers keeping the following points in mind:

1. Made in the Name of the Employer: The auditor should see whether the voucher is made in the name of the employer of the concern.
2. Printed Form: He should see whether the voucher is on a printed form.
3. Serial Number: He should see whether all vouchers are consecutively numbered and filed in order of the entries in the various books.
4. Date, Name, Amount, etc.: The auditor should check date, name of the party to whom the voucher is issued, the name of the party issuing the voucher, and the amounts, etc.
5. Cancelled by Stamp: The vouchers, which are inspected by the auditor, should be cancelled by a stamp so that it cannot be produced again.
6. Related to the Firm: The auditor should also see that all the vouchers are related with the business or not and see whether the payments made by the concern relate to the business or not. The auditor should pay special attention to those vouchers, which are in the personal name of one of the partners, directors, manager or officers of the company.
7. Special Mark in case of Detailed Checking: In case of vouchers, which require detailed checking, the auditor should put special mark on them. He should check such vouchers carefully.
8. Passing of Vouchers: The auditor should see that a responsible senior officer of the concern passes every voucher correctly and the rubber stamps are affixed. He should also see whether the responsible official signs them.
9. Stamped: If the amount of voucher exceeds Rs.500 it must be stamped. The auditor should note whether the vouchers are stamped too.
10. Not to take the Help of the Employees: The auditor should not take the help of the employees of the concern while checking the vouchers.
11. Type of Account: The auditor should see whether the payment is made to a capital account or revenue account.
12. Related to the Year under Audit: The auditor should see that the vouchers are related to the year for which the auditing is going on.

13. Amount in Words and Figures: The auditor should also see that the figures and words of the amount in the vouchers are the same.

14. Points Regarding Further Verification: If any transaction requires further verification of any other evidence such as Memorandum of Association, Articles of Association, Prospectus, Partnership Deed, etc. they shall be noted.

15. Not to Accept Invoice as a Voucher: The invoice should not be accepted as voucher because there are a lot of chances of double payment i.e., once in the form of credit purchase and second time in the form of cash purchase.

16. Not to Accept the Mutilated Vouchers as such: In case if any voucher is mutilated or the amount therein is cut then the auditor should not accept such vouchers as such. They should be made signed by any senior responsible officer of the concern before they are accepted.

17. Pad Paper is not Voucher: Pad papers should not be accepted as vouchers because in such case chances of fraud are more.

18. Time of Payment: The vouchers for insurances, rates, and taxes, etc. should be checked by the auditor with reference to the period for which the payment has been made. In case of payments in advance, the auditor should see whether correct adjustments have been made.

1.6.5.1 Self check exercise-1

1. what is the importance of vouching?

1.6.6 Vouching of cash book

All transactions whether it is cash receipts or payments should be accounted in the cash book. It is an important financial book of a business concern. While vouching, the auditor should verify and satisfy himself that vouchers in the form of receipts, bills, invoices, cash memos etc., correspond with the entries in the cash book. Further, he must go behind the books and establish accuracy and correctness of the entries after thoroughly examining all the original documentary evidences. Therefore, the auditor should ensure that all receipts have been recorded in cash book and no fictitious payments appear on the payment side of cash book.

Objectives:

- To verify that the closing cash bank balance are correctly struck.
- To ensure there is no unauthorized or fraudulent payments are made.
- To ascertain that all the expenses and receipts are shown under the correctheads.
- To ascertain that all the expenses and receipts are shown under the correctbook.

1.6.7 Auditors Duty in Vouching Cash Transactions

The procedures in regard to vouching the transactions of various items which appear in the debit side of the cash book are discussed below:

1. Auditor should see that all the vouchers are properly filed, serially numbered and

arranged date wise. He should also obtain duplicates of lost or missing vouchers

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 transactions must be in conformity with the nature of the client's business. All unusual transactions must be carefully enquired into.
4. Missing vouchers should be carefully noted and brought to the knowledge of the owner of the business.
5. All vouchers must be checked and passed for payment by some responsible official. Similarly any alteration in the vouchers must also be supported by a responsible official.
6. All the receipts of the day should be deposited in the bank at the end of the day or the next morning.
7. Bank reconciliation statement should be prepared frequently by the cashier to verify the bank balance with cash book and pass book. He should also examine the reasons for the difference between the bank balance as per pass book and that in the cash book.
8. All payments as far as possible, except for petty cash, should be made by cheques or online. If large amounts appear to have been paid in cash, contrary to the usual practice of the business, auditor must ascertain the circumstances in which it was considered necessary.
9. Auditor should ascertain that the vouchers have been correctly posted to the appropriate accounts and distinction has thoroughly been observed between capital and revenue expenditure.
10. Auditor should ascertain that the cashier do not sanction any payments of special nature without proper approval from the directors.

1.6.8 Vouching the Receipt side of Cash book

Opening Balance: the opening balance on the debit side of the cash book should be compared with the balance shown in the last audited Balance Sheet to ensure that actual balance has been brought down. Voucher to be vouched – Last Audited Balance Sheet.

Cash Sales: There are greater chances of fraud under this head and so much care should be taken. There is a possibility that salesmen sell goods and do not make entries in the cash book and misappropriate the money. In order to avoid this type or fraud, it is suggested that the following system should be adopted: 1. Salesman should not be allowed to receive cash from customers and a person other than the salesmen should be asked to deliver the goods. 2. He should be directed to prepare four copies of the memo of the goods sold, of which three copies are to be handed over to customer; and he has to keep one copy with him. 3. The customer goes to the counter with three copies. The cashier receives the payment and retains one copy with him and the other two copies of the cash memos are returned to the customer with “Cash Received” or “Cash Paid” seal. 4. The gatekeeper collects and retains the fourth copy with him who hands over the goods to the customers. 5. At the end of the day the salesman, cashier, and the gatekeeper prepare summaries and send them to the General Manager. In vouching the cash sales, cash register should be fully checked with carbon copies of cash memos.

Cash Received from Debtors: When cash is received from customers, a cash memo is issued; the receiving clerk retains a counterfoil or carbon copy of such cash memo. The counterfoil is the only proper documentary evidence available for vouching. So the cash received from debtors can be vouched with reference to the counterfoils of the receipts issued to them. However, this is not a reliable voucher as frauds are usually committed in the following ways: 1. Entering loss amount in the counterfoil than what is actually received from a debtor. 2. Recording less amount on the debit side of the cash book.3. Issuing a receipt from the unused books. This is possible when they are not kept in safe custody. Sometimes payments received from a customer is misappropriated without making entry in his account and later on when cash is received from another customer, it is posted to the account of former customer; this is known as teeming and lading Vouchers to be Vouched — Counterfoils, Correspondence, etc.

Loans: In case, the company obtained any loan, its receipt should be vouched with the agreement entered into with the lender. The auditor should see whether his client is entitled to raise loan. He should examine the rate of interest payable, the terms of repayment, and the security offered, etc. The auditor should see whether security offered is indicated in the Balance Sheet and the interest due but not paid at the Balance Sheet date is adjusted in the accounts. Vouchers to be Vouched — Legal Provisions, Agreement, and Value of Security Offered.

Sale of Investment: The amount received due to the sale of investments should be vouched with the broker's sold note. If they have been sold through bank, bank advice should be examined. In case they have been sold "Cum-dividend", he should see whether the dividend is received later and that the sale proceeds are apportioned properly between capital and revenue. Vouchers to be Vouched Bank Advice, and Broker's Sold Note.

1.6.9 Vouching of the payment side of Cash Book

Opening Balance- Cash book may have credit balance in bank Coolum this balance can be verified from the previous year's balance sheet .

Cash Purchase the auditor should take the following steps: Purchases are supported with cash memos or invoices. See that only net amounts, that is, purchases minus trade discount, has been carried to the books of account. Goods have been actually received and that included in stock. He should check goods received book.

Payment of creditors (i) The receipts issued by the creditors acknowledging the receipt of money should be checked. (ii) The money paid should be compared with the money due as per the accounts of the creditors and the invoices received from them. (iii) He should scrutinize the method of comparing the statement of accounts with their actual accounts. (iv) Before passing an entry in this regard, he should refer to minutes, contracts and other documentary evidence.

Payment of Wages:- Payment is properly authorized. Each worker is paid the correct amount. No fictitious names of workers are included. There is no falsification of wage records. Payment of wages is properly recorded.

Salaries: For this, salaries book containing the details of the employee's salary should be maintained. The auditor should take the following steps: (i) He should compare the cheques drawn with the salaries book. (ii) Any change in the salary list should be verified with an official source. (iii) Special attention should be paid to the deductions in respect of provident fund, life insurance premium, income tax, etc. (iv) Independent information as regards employees leaving the service of the concern should be obtained from the staff departments and compared with the salaries book to find out persons already left being included in the salaries book. (v) He should ensure that the payment has been made to the correct person. This he can do by comparing the signature on the salaries book with the specimen signature of the employees.

Plant, Machinery, Furniture & Fixtures : In this connection, the auditor should take the following steps (i) examine the invoices and the receipts obtained from the supplier and see that the items have been properly authorised. (ii) In case, machinery has been purchased on hire-purchase basis the auditor should examine the contract of hire- purchase with the vendors to find out the purchase price, the amount of instalment and interest. Here, he should note that only the principal amount has been capitalised.

Land & Building: The auditor should take the following steps: (i) The documents of title of the property purchased should be examined. (ii) The auditor should find out as to whether land or buildings purchased are on freehold or leasehold basis. In latter case, he should examine the terms of the lease. (iii) If the properties are purchased through an auctioneer, the account submitted by the auctioneer should be checked. (iv) In case the property has been purchased through the broker, the broker's note should be examined. (v) Where the property is got erected through a contractor, he should examine the receipts issued by the contractor, for payments made. (vi)The expenses incurred, for example, auctioneer's commission, brokerage, architect's fee, registration fee etc. can be vouched with the help of the receipts obtained and it should be seen that they are capitalised.

Insurance Premium - Insurance policy documents along with premium payment receipt should be examined by the auditor. Rent Auditor should verify the payment of rent from the agreement. The rent voucher should be supported by rent receipt from the land lord. It should be seen that payment of rent is sanctioned by responsible officer Directors Fee: The auditor should take the following steps in vouching the payments under this head; (i) examine the articles to find out the fee payable to the directors. (ii) The director's minute book, the attendance register should be examined to ascertain the number of meetings attended by them. (iii) Examine the receipts obtained from directors for this payment.

Vouching of trading transaction-

After having completed the vouching of cash transactions, the auditor should proceed to examine the trading transactions. Trading is a business process starting with the purchase of goods and ending with sale. The major trading transactions are purchase, purchase returns, sales and sales returns. The main objective of vouching trading transactions is to detect misappropriation of goods. Therefore, the auditor should take great care in vouching trading transactions to prevent misappropriation of goods.

Vouching of Credit Purchases

Transactions relating to credit purchases are recorded in Purchase Book. The main objective of vouching purchase book is to ensure that all the goods purchased during the year are being received and the client makes payment only for the goods being delivered by the supplier. The auditor before vouching the purchase book should satisfy himself about the effectiveness of the Internal check and control system relating to purchases.

Auditors Duty :

While vouching purchase book the auditor should consider the following points:

1. The auditor should carefully check the entries in the Purchase Book with the purchase invoices. While examining the purchase invoice the auditor should pay attention to the following points:-

a. Invoices are in the name of the client .b. The date of the invoice should relate to the period under audit. c. The name of the creditor in the invoice agrees with the name entered in the purchases book. d. Orders should be placed by a responsible officer and there should be another responsible officer to pass the invoice for payment. e. Invoice should be initialled by the Invoice clerk as being checked.

2. The auditor should vouch the entries in the Purchase Book with the invoices, copies of orders placed, Goods Inward Book and delivery notes.

3. He should ensure that only credit purchases are recorded in the Purchases Book.

4. He should also ensure that purchase of capital goods, i.e., purchase of plant and machinery or any capital asset are not entered in Purchase Book. But instead they should be accounted in fixed assets account.

5. Auditor should check the totalling and casting of the purchases book and ensure that all taxes and freight are added to the purchases and trade discount allowed are deducted.

6. When directors or partners purchase goods for personal use, auditor should ensure that such purchases are charged to their personal accounts.

7. Auditor should compare the Gatekeepers Goods Inward Book and the stock sheets with the purchases book to ensure that all goods taken into stock have been entered in the purchases book. Books and Documents to be Vouched:

(1) Purchase Invoice, (2) Purchase Book, (3) Suppliers ledger account, (4) Gatekeepers Goods Inward Book. Example:

On 5.1.2019, X Ltd. purchased 30 cotton shirts @ Rs.150 each worth Rs.4, 500 from cotton Mills, Delhi on credit.

Vouching of Credit Purchases. Auditor should vouch the transaction in the following manner:

1. Verify entry in Purchase Day Book with respect to date of purchase, invoice number, name of supplier and amount of purchase.

2. Verify entry in Suppliers Account with regard to date and amount of purchase.

Purchase Day Book

Date	Purchase Invoice No	Name of the Customer	L.F	Details Qty	Amount
2019,Jan 5	210	Cotton Mills, Delhi		30	4,500

Cotton Mills (Creditors /Suppliers) Delhi Account

Dr.
Cr.

Date	Particular	Folio	Amount	Date	Particular	Folio	Amount
				2019, Jan. 5	By purchase		4,500

Vouching of Purchase Returns

Goods returned by the client to the suppliers due to poor quality, defective goods and goods not according to the sample are recorded in the Purchase Returns Book. When the goods are returned, the supplier's account should be debited. The debit is made through the purchase returns book on the basis of a Debit Note. The supplier, on receipt of the debit note issues a Credit Note indicating the acceptance of the debt.

Auditors Duty

Auditor before vouching purchase returns should ascertain that a proper system of internal check is in existence and should ensure that full credit is obtained for all goods returned. Further, the auditor should proceed to vouch purchase returns in the following manner:

1. When goods are returned, auditor should verify whether it is properly recorded in the Purchase Returns Book or Returns Outward Register.

2. Auditor should verify the debit note issued by the client to the supplier or the credit note issued by the supplier.

3. He should vouch the quantity returned with the Purchase Returns Book, Gatekeepers Outward Register, storekeeper's record and credit notes received from the supplier.

4. The auditor should verify the purchase returns of the first and last month of the year to avoid manipulation of accounts.

5. The auditor should ensure that current year's returns are not accounted in the subsequent year.

Books and Documents to be Vouched: (1) Debit Note, (2) Purchase Returns Book or Returns Outward Register, (3) Suppliers Account, (4) Gatekeepers Outward Register.

Example

On 15.1.2019, X Ltd. returned 10 damaged cotton shirts to Cotton Mills, Delhi.

Vouching of Purchase Returns

Auditor should vouch the transaction in the following manner:

1. Verify debit note which is issued to the creditor or supplier for goods returned.

2. Verify entry in Purchase Returns Book with respect to debit note, date of return, name of supplier and amount of return.

3. Verify entry in Creditors or Suppliers Account with regard to date and amount of return.

Debit Note

X LTD.

224,Jawarharlal Nehru Road, Chennai

Debit no-22

Date :15th Jan.2019

Particulars	AMOUNT
Good returns to Cotton Mills Delhi as par delivery challan no 37 towards damaged shirt 10,vide invoice no 210 ,date 5/1/2019	1500

Signature of Manager

Purchase Return Book

Date	Purchase Invoice No	Name of the supplier	L.F	Details Qty	Amount
2019, Jan 15	Debit Note no	Cotton Mills, Delhi		10	1,500

Cotton Mills Delhi Account (Creditors)

Dr.

Cr.

Date	Particular	Folio	amount	Date	Particular	Folio	Amount
2019, Jan. 15	To purchas Return		1500				

Vouching of Credit Sales

In Sales Book, only credit sales of goods are recorded. Auditor before vouching the sales book should check the effectiveness of the system of internal check and control in operation.

Auditors Duty

The auditor should carry out vouching of credit sales in the following manner:

1. The auditor should verify the efficiency of the system of Internal check in operation by test checking the transactions.
2. Auditor should vouch Sales Book with the copy of the invoices, Orders Received Book and Goods Outward Book and ensure that all sales made are accounted.
3. He should check the casts, postings and carry forwards of the Sales Book.
4. He should see whether there is any omission or inflation of sales.
5. Auditor should ensure that sale of capital assets are not considered as ordinary sales and accounted in Sales Book.
6. Trade discounts allowed to customers should be checked and differences if any observed should be enquired.
7. Auditor should check that cancelled invoices are properly cancelled and kept separately.
8. To detect fraud, the auditor should prepare a statement of accounts of the customers and send it to the customers to confirm the accuracy of the balance.
9. Auditor should carefully vouch the entries made in the sales book of the last few weeks to ensure sales belonging to the next financial period are not treated as

current year's sales or fictitious sales not being recorded in the books which will inflate the profit.

Books and Documents to be Vouched: (1) Sales Invoice, (2) Sales Book, (3) Customers ledger account, (4) Goods Outward Book.

Example:

On 5.2.2019, X Ltd. sold 20 shirts for Rs.200 each to Ram & Co., Bangalore on credit.

Vouching of Credit Sales

Auditor should vouch the transaction in the following manner:

1. Verify entry in Sales Day Book with respect to date of sale, invoice number, name of customer and sale amount.

2. Verify entry in Debtors or Customers Account with regard to date and amount of sale.

Sale Day Book

Date	Sales Invoice No	Name of the Customer	L.F	Details Qty	Amount
2019,Feb 5	112	Ram & Co., Bangalore		20	4,000

Ram & Co., Bangalore (Debtors /Customers) Account

Dr.

Cr.

Date	Particular	Folio	Amount	Date	Particular	Folio	Amount
2019, Feb 5	To Sale		4,000				

Vouching of Sales Return

Goods which have been sold when return by the customer on account of poor quality, defectiveness or due to other reasons are accounted in Sales Returns Book. The auditor should bear in mind the following points while vouching them:

1. The auditor should vouch the entries in the Sales Returns Book with the Gatekeepers Returns Inwards Book and Stock Register.
2. Auditor should verify the copy of the Credit Note issued to the customer and ensure that the credit note is properly authorized and signed by a responsible officer.
3. He should check the postings from the Sales Returns Book to the Sales Returns Account and Customer Ledger.
4. He should verify the returns from the customers at the beginning and end of the year.
5. He should ensure that goods returned by the customers are included in closing stock and are valued at cost or market price whichever is less.

Books and Documents to be Vouched: (1) Sales Returns Book, (2) Credit Note, (3) Customers ledger, (4) Gatekeepers Returns Inwards Book, (5) Stock Register.

Example:

On 8.2.2018, Ram & Co. returned 10 shirts @ Rs.200 each to X Ltd.

Vouching of Sales Return

Auditor should vouch the transaction in the following manner:

1. Verify credit note which is issued to the creditor or supplier for goods returned.
2. Verify entry in Sales Returns Book with respect to credit note, date of return, name of customer and amount of return.
3. Verify entry in Debtors or Customers Account with regard to date and amount of return.

Credit Note

X LTD.

224,Jawarharlal Nehru Road,Chennai

Credit no-18

Date :8th Feb.2019

Particulars	AMOUNT
Good returned to Ram & Co. as per delivery challan no 147 towards damaged shirt 10,vide invoice no 11 ,dated 8/2/2019	2000

Signature of Manager

Sales Return Book

Date	Credit Note no	Name of the Customer	L.F	Details Qty	Amount
2019, Feb 8	18	Ram & Co.		10	2000

Ram & Co. Bangalore (Debtors) Account

Dr.

Cr.

Date	Particular	Folio	Amount	Date	Particular	Folio	Amount
				2019,Feb.8	To Sale Return		2000

5. Vouching vs. Verification-

Vouching is the soul of Auditing because it forms a base for an effective audit procedure. Vouching means “to vouch” i.e. examine the vouchers. On the other hand, Verification means “to verify” the assets and liabilities of the business. Both the two terms are the first two steps of Auditing, infact vouching helps in the process of verification.

Comparison

Basis for comparison	Vouching	Verification
Meaning	Vouching means checking the accuracy of the transactions recorded in the books of accounts.	Verification means a process to substantiate the validity of assets and liabilities appearing in the balance sheet.
Basis	Documentary Evidence	Observation and documentary
Examination	Item of profit & loss	Item of balance sheet

	account	
Carried out	Audit clerks	Auditor
Time horizon	Year round	At the end of the financial year
Objective	To examine the correctness, validity and completeness of the transactions.	To confirm the ownership, possession, existence, valuation and disclosure of the items appearing on the balance sheet.

1.6.9.1 Self check exercise-2

1. how verification of assets is done?

1.6.10. Summary

Vouching is a technical term that refers to the inspection by the auditor of documentary evidence supporting and substantiating a transaction. In this chapter, vouching has been introduced. Vouching of cash transactions is discussed. The auditor's duties regarding vouching is also given in detail.

1.6.11. Glossary

a) Ltd.- limited
b) L.F.- Ledger Folio

1.6.12. Questions for Exercise

1. Comparision between vouching and Verification?.
2. Define vouching cash book ?
3. Explains the feature of vouching ?
4. write short note on:
   a) What is vouching
   b) What is verification

1.6.13.SUGGESTED READING

1. Auditing : Dr T.R Sharma
2. Auditing: Theory and Practice : Arun Kumar, Rachana Sharma

LESSON NO. 1.7

VERIFICATION AND VALUATION

1.7.1 OBJECTS OF VERIFICATION

Following are the objects of verification of assets and liabilities

1. To show correct valuation of assets and liabilities.
2. To know whether the balance sheet exhibits a true and fair view of the state of affairs of the business
3. To find out the ownership and title of the assets
4. To find out whether assets were in existence
5. To detect frauds and errors, if any
6. To find out whether there is an adequate internal control regarding acquisition, utilisation and disposal of assets.
7. To verify the arithmetic accuracy of the accounts
8. To ensure that the assets have been recorded properly

1.7.2 INTRODUCTION OF VERIFICATION

MEANING OF VERIFICATION

Verification is a process by which an auditor satisfies himself about the accuracy of the assets and liabilities appearing in the Balance Sheet by inspection of the documentary evidence available. Verification means proving the truth, or confirmation of the assets and liabilities appearing in the Balance Sheet.

Spicer and Pegler have defined verification as "it implies an inquiry into the value, ownership and title, existence and possession and the presence of any charge on the assets".

Thus, verification includes verifying :-

1. The existence of the assets
2. Legal ownership and possession of the assets
3. Ascertaining that the asset is free from any charge, and
4. Correct valuation

1.7.3 SCOPE OF VERIFICATION

Verification includes information on the following :-

1. That the assets were in existence on the date of the balance sheet
2. That the assets had been acquired for the purpose of business only
3. That the assets had been acquired under a proper authority
4. That the right of ownership of the assets vested in the organization
5. That the assets were free from any charge and
6. That the assets were properly valued and disclosed in the balance sheet.

1.7.4 TECHNIQUES OF VERIFICATION

1. Inspection : It means physical inspection of the assets i.e. company cash in the cash box, physical inventory, inspection of shares certificates, documents etc.

2. Observation : The auditor may observe or witness the inspection of assets done by others.

3. Confirmation : It means obtaining written evidence from outside parties regarding existence of assets.

1.7.5 VERIFICATION OF ASSETS

The term `verification' signifies the physical examination of certain class of assets and confirmation regarding certain transactions. Sometimes verification is confused with vouching but they differ from each other on the nature and depth of the examination involved. Vouching goes to prove the arithmetical accuracy and the genuineness of the transactions, whereas verification goes to enquire into the value, ownership, existence and possession of assets and also to confirm whether they are free from any mortgage or charge. The fact of the presence of any entry regarding the acquisition of asset does not prove that the particular asset actually exists on the Balance Sheet date, rather it purports to prove that the asset ought to exist; on the other hand, verification through physical examination and confirmation proves whether a particular asset actually exists without having any charge on the date of the balance Sheet.

Verification of assets involves the following steps:

1. Enquiry into the value placed on assets;
2. Examination of the ownership and title deeds of assets;
3. Physical inspection of the tangible assets; and
4. Confirmations regarding the charge on assets;
5. Ensuring that the assets are disclosed, classified and presented in accordance with recognized accounting policies and legal requirements

The scope of verification is wide and consequently verification is an important part of the auditor's duties. An auditor should put all his endeavor to satisfy himself whether a particular asset is shown in the Balance Sheet at proper value, whether the concern holds the title to the asset and the asset is in the sole possession of the concern and lastly whether the asset is free from any charge. If the auditor fails to perform his duty, he will be held liable. In case of London Oil Storage Co. Ltd. Vs. Sear Hasluck & Co. (1904) Chief Justice Alverstone remarked : `It is the duty of the auditor to verify the existence of the assets stated in the Balance sheet and he will be liable for any damage suffered by the client if he fails in his duty.

1.7.5.1. Self check exercise- 1

1. explain various techniques of verification.

1.7.6 VALUATION OF ASSETS AND LIABILITIES OF A BUSINESS:

1.7.6.1 VALUATION OF ASSETS:

Valuation of assets means determining the fair value of the assets shown in the Balance Sheet on the basis of generally accepted accounting principles. The valuation of assets is very important because over-statement or under-statement of the value of assets in the Balance sheet not only distorts the true and fair view of the financial position but also gives wrong position of profitability.

The auditor has also to see that the principle of valuation of assets is consistently adopted and is based on established principles of accountancy. For the purpose of convenience, those assets are classified as under to determine their value.

1. Fixed Assets
2. Current Assets or Floating Assets
3. Intangible Assets
4. Fictitious Assets

1. Fixed Assets : Fixed Assets are usually valued at `going concern value' which means cost less depreciation. Cost here means purchase price of the assets plus all incidental manufacturing, buying and installation expenses incurred to bring the assets in use. Depreciation is the provision made for the reduction in the value of the assets on account of their usage, natural wear and tear and obsolescence etc. The depreciation provided should be fair, otherwise the value of fixed assets may not be fair. What is a fixed asset depends on the nature of the business organization.

2. Current Assets or Floating Assets : These are usually converted into cash at the earliest opportunity in the process of business activity, e.g. stocks, bills receivables, sundry debtors, etc. Based on conservatism principle, usually current asset are valued at original value (cost price) or market value (realizable value) whichever is lower. Because they are intended to be converted into cash at the earliest possible time, hence what value we may realize is important. This method is adopted to strengthen the financial position of a concern by indirectly providing for expected loss by way of fall in the market value of the assets. This principle is held by the conservatism convention of accounting, i.e. do not expect profits but provide for anticipated losses.

3. Intangible Assets : Usually intangible assets like goodwill, patent rights, know how, etc. are valued on cost basis. But if the same are acquired by a non-cash transaction, then the fair market value is to be taken as the value of intangible assets. Auditor should also see the period of time and till it is fully written off, they are shown as assets because they do not have any realizable value. They are to be valued at actual cost less amount written off as depreciation upto Balance Sheet date.

4. Fictitious Assets : Certain lumpsum expenses giving benefit for more than one year when incurred are written off over a period of time, and till it is fully written off, it is shown as an asset in the Balance Sheet e.g. preliminary expenses, discount on issue of shares etc. These are all ficitious assets because they do not have any realizable value. They are to be valued at actual cost less amount written off upto the Balance Sheet date.

Methods of Valuation The following are the various principles of valuation of assets

(1) Cost Price (Going Concern Value): Under this method actual cost of assets are reduced by the depreciation provided. Usually this method is applied to value fixed assets.

(2) Market Value: This refers to the market value of the asset i.e. the price at which the asset is being transacted in the market. This is applied to value the current assets only when this is lower than cost of the asset. Usually market value is adopted to value items having perishable nature.

(3) Scrap Value: Assets which are useless for the enterprise may be sold as scrap in the market. The value for which such assets can be disposed of as scrap, is called as scrap value of assets.

(4) Replacement Value: This represents the value at which the existing assets can be replaced. That means the price to be paid to acquire such type of assets in the market on the date of the balance Sheet.

(5) Realisable Value: The value that can be obtained if the asset is sold in the market i.e. anticipated selling price. Usually, expenses such as commission, brokerage etc. are deducted from it.

Revaluation of Assets:

There may be periodical revaluation of assets (i.e., revision of book values) by a systematic assessment so as to show a more realistic value of assets based on the physical condition and estimated future working life of assets, trend of market prices, etc. It may be noted that reserve created on revaluation, if any, would not be available for distribution.

Revaluation may be done on basis of:

(a) A number of factors like technical up gradation, replacement cost, productivity and efficiency of the assets; or

(b) Historical cost, which does not reflect a true and fair view of the affairs, suitably revised to indicate realistic value.

Revaluation is made on the basis of- (a) replacement cost (net realisable value having regard to market trends) as reduced by accumulated depreciation; or (b) indexation method based on industrial indices; or (c) appraisal method i.e. valuation by expert values or appraisers like architects, engineers, certified values.

Accounting Standard AS 10 issued by the Institute of Chartered Accountants of India provides that the revalued amount of a fixed asset should be shown in the financial statement by restating both the gross book value and the accumulated depreciation to give the net revised book value, or by restating the net book value by adding the net increase thereof.

The selective revaluation processes as above are not available under instructions for making out assets contained in Schedule VI to the Companies Act, 1956, which require that in case of any writing up of the asset(s) it must be shown at its increased figure in the Balance Sheet subsequent to such writing up.

Auditor’s Duty towards Valuation of Assets:

An auditor should inquire into the basis of valuation of all assets and liabilities used or adopted by client with the greatest care before finally passing any item.

He should be thoroughly satisfied that they have been properly valued or revalued on scientific principles so as to represent their true and fair worth to the business at the date of the balance sheet. It is, however, no part of an auditor’s normal duty to value assets or liabilities himself.

That work is usually done either by a responsible officer of the business or by some independent and expert valuer and, in such circumstances, an auditor's responsibility is confined to the acceptance of certificates of value from the management or the valuer, as the case may be, subject, of course, to suitable personal inquiries made by himself to establish that the values appear to be reasonable having regard to the nature of the business and of the assets or liabilities concerned.

In any case, an auditor is not responsible for valuation of assets and liabilities provided he exercises reasonable skill and care in scrutinising the basis of valuation (London & General Bank case; Kingston Cotton Mills case; Westminster Road Construction Co. case.

Valuation and Verification of Particular Assets:

Subject to the general principles of valuation and verification discussed above an auditor should always take into full consideration special points in regard to the valuation and verification of individual items of assets on the basis of their precise nature and utility.

Cash, book debts and stock-in- trade constitute three important assets requiring very careful attention and, as such, their valuation and verification aspects are fully discussed below followed by the enumeration of main points in relation to other assets in a tabular form:

(i) Cash Balance:

There can be no separate basis of valuation in respect of cash balance except that the actual balance in hand must be the same as indicated by the cash book; in other words, an auditor is required to verify the existence of cash balance in hand on the closing date.

For this purpose the matter is to be handled separately in respect of various types of cash balance as under:

(a) Cash at bank:

As the balance remains with the bank no physical verification is possible; only a documentary verification has to be conducted. For this purpose the bank balance, as shown by the 'bank column' of the cash book, should be compared with the corresponding figure of the bank pass book.

The bank reconciliation statement should also be checked. If a discrepancy still persists, casting and balancing of the pass book itself may be checked. It is desirable to obtain a certificate or confirmation from the bank about the balance held by it. In case of fixed deposits, deposit receipts from the bank should be seen; if such receipts are pledged, certificates from pledges should be obtained.

(b) Cash in hand including petty cash:

Physical verification is the only effective method of verification, i.e., if possible, cash in hand should be actually counted by an auditor on the closing date. As, however, it is not practicable to attend offices of all clients on the closing date, for this purpose, verification is usually done after that date.

In such cases, an auditor should attend as early as possible after the closing, carefully vouch cash transactions from the date of closing up to the date of the visit and count the actual cash in hand on the latter date. Sometimes a system of depositing the closing cash balance with the bank on the closing date and withdrawing the same on the next day may be followed when the bank pass book will provide the only reliable source of verification.

In case of organisations like banks etc. holding large cash balances at any time, complete physical checking is not practicable and test checking has to be adopted, provided a good system of internal control is in operation. Bundles of notes may be counted, checking some of them in detail. Bullion or coins may be verified by taking the average weight of bags containing the coins, actually counting some of the bags picked up at random.

An auditor should insist on the production of all cash balances at a time to prevent substitution with a view to covering up defalcations. According to the decision of the London Oil Storage Co. case an auditor will be liable for negligence if he fails to verify cash balance.

(c) Cash held by officers:

An auditor should not ordinarily accept a certificate from an official about large cash balance held by him. When such a practice is unavoidable the auditor should see that it is properly authorised and is absolutely necessary for the genuine purpose of business and that the balance is within the limit fixed, if any, and is not allowed to remain with the officer concerned indefinitely.

(d) Cash with branches and agents or in transit:

It is not possible for an auditor to personally count cash balances at different branches or lying with various agents or in transit; he has, therefore, to be satisfied with proper documentary evidence.

Where a system of depositing branch or agents' balances on the last working day of a financial year with banks is followed, an auditor should see the bank pass book and also obtain certificates from the banks concerned about the balances held by them. In case of cash in transit, the respective advices from branches or agents should be scrutinised.

(ii) Book Debts:

An auditor's primary duty is to see that book value of sundry debtors has been correctly ascertained. The basis of valuation should be net realisable value after deducting bad and doubtful debts.

The schedule of debtors' accounts extracted from the debtors' ledger and certified by the management should be compared with the balance of the total debtors', account in the general ledger when the self-balancing system is in operation. Checking of the items appearing in the said schedule of debtors with individual statements of accounts and/or confirmation of balances received from customers is also a useful method of verification.

A very important matter about verification of book debts is the checking of adequacy or otherwise of the provision for bad and doubtful debts.

In this connection an auditor should obtain a certified schedule of bad and doubtful debts from the management and he should thoroughly check the same paying special attention to the following points:

(a) Checking year-end balances and subsequent realisations.

(b) Age of the debtor's balances. See if there is any debt which is already time-barred or is nearing the end of the period of limitation.

(c) Whether regular payments are being made as per terms of credit allowed. Particularly look out for overdue payments.

(d) If cheques or bills of any customer have been dishonoured.

(e) If there is any history of bankruptcy or attachment of the funds and properties of any debtor.

(f) If any suit had to be instituted against any debtor for recovery of dues.

(g) Whether the balances of-individual debtors are stable, increasing or diminishing.

(h) Checking provisions for allowances, discounts, bad and doubtful debts, if any.

(i) Checking Debtors' Ledger Trial Balance with Control A/cs.

(j) Particularly enquire about suppression of sales leading to suppression of debtors.

On a careful consideration of the aforesaid information an auditor should make his own estimate of probable bad or doubtful debts and compare the same with the provision made by the management. If he is not satisfied with the provision he should, in the first instance, discuss the matter fully with the management trying to persuade them to correct the position, failing which he should mention the fact in his report.

Arthur E. Green & Co. case clearly established that an auditor will be liable for negligence if he accepts a schedule of bad debts without being able to detect time-barred debts included therein.

(iii) Stock-in-Trade or Inventory:

This is one of the most important items in respect of which frauds are perpetrated and, as such, it should receive the most careful attention of an auditor. It comprises stores and spares, loose tools, raw materials and components, work-in-process and finished goods.

(a) Valuation of stock:

The fundamental basis of valuation in respect of stock is 'cost or market value, whichever is lower'. Cost includes cost of purchase/acquisition or conversion, other costs in bringing the items to present location or condition.

The exact implication of the terms cost and market price which should be clearly understood, are outlined below:

(i) Chief Types of Cost:

1. First-in-first-out method:

It is assumed that the materials or stocks are used or despatched in the chronological order of their receipt so that the closing balance in hand would consist of the items acquired towards the end of the year. The prices of such latter purchases are, therefore, taken as the basis of ascertaining cost of the closing stock.

2. Last-in-first-out method:

Just a reverse order is followed assuming that items received last are used or disposed of first so that the balance in hand would represent earlier purchases; its cost is, therefore, assessed on the basis of earlier purchase prices.

3. Average cost method:

Average is taken of the different rates at which particular items have been bought at different times during a year and that is taken as the basis of cost in respect of the stock in hand at the close of the year. In view of the practical difficulties in calculating cost strictly according to the first two methods the average cost method is the most popular and common due to its simplicity.

4. Standard cost method:

Stock is valued at a fixed cost per unit which may be regarded as a cost-budget for each item.

(ii) Chief types of market value:

Description:

1. Realisable value
2. Replacement value

Nature:

Value that the stock is expected to realise if sold at the market price ruling on the closing date minus selling cost. Amount that would be necessary to replace an existing stock or to acquire similar stock at the prevailing market price

N.B. Although both realisable and replacement values are based on market prices there is a fine technical distinction between the two. The chief idea behind the former is the sale or disposal of stock, whereas that behind the latter is the purchase or acquisition of similar stock in replacement of an existing one.

Usually the prices at which a particular item can be bought or sold at any particular time differ and this variation must be taken into account in assessing market values under the ‘realisable’ and the ‘replacement’ methods.

The precise applications of the aforesaid criteria for ascertaining cost or market value of different groups of stock items are indicated in the under noted table:

(b) Verification of stock:

Physical existence of stock items represented by the stock figure in the balance sheet is usually verified by actual annual or half-yearly stocktaking arranged by the management and necessary reconciliation is made with book figures as per bin cards or store ledger accounts.

An inventory or schedule of all items is prepared at the time of stock-taking and each item is valued on one of the accepted principles as discussed above and such a schedule is usually certified by an engineer or other expert, a director, manager or high official for authentication.

Sometimes a system of continuous stock-taking is adopted instead of periodical stock-taking to cover substantial part, if not whole, of the inventory. This inventory forms the basic document for inclusion of stock-in-trade in the balance sheet. Separate inventories for stocks on consignment, on hire-purchase and on sale or return should also be similarly prepared.

(c) Auditor’s position re: stock-in- trade:

‘It is an accepted principle that an auditor is not a valuer of stock as he is not supposed to possess expert knowledge regarding the nature and utility of various stock items nor is he in a position to count or verify the physical existence of each and every item of the inventory, particularly in the case of a big manufacturing or trading concern holding a large variety of items in stock.

In practice, an auditor is obliged to depend on the system of internal control and to accept the certified inventory as the basic documents for checking the valuation of and also verifying the stock.

The Kingston Cotton Mills Co.’s case established that an auditor is entitled to accept and rely on stock-sheets certified by a responsible officer in the absence of suspicious circumstances and that he is not to take stock himself. Evidently, acceptance of a certified inventory is conditional upon the 'absence of suspicious circumstances'; an auditor should not blindly accept a certificate of stock provided by the management. To be sure that there is no ground for suspicion he should carry out proper independent checking of the stock- sheets as far as circumstances permit; otherwise he may be held liable for negligence in duty.

The Westminster Road Construction Co. Ltd. case established that an auditor would be negligent in duty if he accepted from management a certificate re: work-in-progress without proper enquiries; according to the decision in Mc Kessan & Robins case of U.S.A. an auditor is expected to be present at and see for himself the actual physical stocktaking.

In actual practice an auditor should apply reasonable care and skill and normally take the following steps in respect of stock-in-trade in order to be able to prove, if necessary, that he exercised reasonable care and skill:

(a) Carefully examine the system of internal control in force and note any possible loopholes therein. Go through programme of stock-taking adopted by management and instructions issued to staff for this purpose.

(b) Obtain stock-sheets containing description, quantity, rate and value of stock including special types of stock, if any, duly initialled by all persons connected with stock-taking and certified by properly authorised person.

(c) Carefully check goods inward and outward books and also purchase and sales records for the last week or so of the accounting year under audit with a view to finding out any purchase and receipt of material that may not have been included in the stock list, or any sale that may have been included although corresponding goods have not been actually delivered to the consumer.

(d) See by means of test checks that a proper basis of valuation is adopted and that the same principle is consistently followed from year to year unless there are valid grounds for changing the basis.

(e) See that non-moving, slow-moving or obsolete stocks, if any, are duly written- off or adjusted and that other assets like loose tools not meant for trading purposes are excluded from the stock- sheets.

(f) Compare percentage of gross profit on turnover with previous year's figure and enquire about any abnormal fluctuation.

(g) Compare some of the items of the stock- sheets, particularly the bigger or material ones, with previous year's list and also with balances indicated by bin cards or stock ledger accounts and ascertain the reasons for discrepancies, if any.

(h) Check casting of stock-sheets and a portion of the calculations.

(i) Verify some selected stock-items physically, if possible, or be present at least for some time during stock-taking. Compare inventories with stock records.

(j) Refer to the year-ending stock statement submitted to bankers under overdraft/ cash credit arrangement, if any.

Verification and valuation of other Different Kinds of Assets:

1. Loans: Loans against Security of Land and Property: The auditor has not only to examine the loan account in the ledger, but he has to examine the documents relating to the security, promissory note or bond, acknowledgements by the parties. If the land or property has been mortgaged, the auditor should examine the mortgage deed. He should examine the title deeds relating to the property. He should enquire the rate of interest and the date on which it is payable. He should see that the mortgage is duly registered. He should see whether has the power to mortgage the property and borrow money. Loans against Security of Stock and Shares: The auditor should get a list of such stock and shares which have been held as security. He should see that such shares are transferred to his client. He should inspect such shares and see that they do not belong to his client. The auditor should get a written acknowledgement from the borrower regarding the amount of loan on the date of the balance sheet or examine the agreement. Loans against Security of Goods: Where loan has been advanced against a Godown keeper's receipt, such a receipt should be examined. He should see that the warehouse rent has been paid by the borrower. He should examine the inspector's report from time to time regarding the quantity of goods.

Insurance Policy: Last receipt for the payment of the premium paid should be examined. The auditor should see the notice of assignment of the policy has been given to the insurance company. Loans against Personal Security: In case the loan has been granted against the personal security, the auditor should make an inquiry regarding the financial position of the surety as the value of such as security depends on his financial position. He should also see that no charge in the terms of loan has been made as such a course will discharge the security and the client loses that security.

2. Bills Receivable: The auditor should examine the Impersonal ledger or Bills Receivable Book with the bills receivable on hand. Some of the bills might have been sent out for collection in which case an inquiry should be made from the bank. While examining the bills, the auditor should see that they are properly drawn, stamped, duly accepted and that they are not overdue. In case there is any doubt about the payment of the bill on the due date, sufficient provision be made.

3. Investments: 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 give full particulars of the investments, e.g., name of 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 payment on interest, tax deducted and so on and compare these with the records in the books of his client.

Valuation of Investments: Having verified the existence of the investments the auditor should now proceed to find out whether they are properly valued at the date of the balance sheet. The basis of the valuation of investments in the balance sheet will, to a large extent, depend upon the purpose for which they are held. If they are held by Trust Company, the object of which is to earn dividends and interest and distribute such dividends and interest amongst the shareholders, such investments are to be treated as fixed assets and, therefore, even permanent fall in their value may be ignored, of course, subject to Articles of Association and the Memorandum of Association of the trust Company.

4 Fixed Assets: The usual method of the valuation of fixed assets is the cost price less deprecation. It has been suggested that during the inflationary period, the replacement cost method should be followed while valuing the assets on the balance sheet date.

5. Endowment Policies: The auditor should physically inspect the policies and see that the premium payable has been paid and that the policy has not lapsed.

6. Patents Rights and Trade Marks: If the client holds large number of patents or trademarks the auditor should ask him to prepare a schedule giving : The description of patent, registered numbers, the dates on which they were acquired, the unexpired period. The auditor should examine the receipts for the payments of the fees. He should also see that the renewal fee has been paid each year at the right time.

7. Copy Right: Copy Right must be revalued at the date of balance sheet. If the publication does not command any sale, the copyright should be written off.

8. Furniture and Fixtures: The auditor should verify this item with the help of invoices. Any addition made during the year should be verified in the usual way. Any expenses incurred in the purchase of these assets should be debited to the Furniture account. The auditor should see that proper depreciation is provided and that the net figure is shown in the balance sheet.

9. Plant and Machinery: This item is also verified by reference to the original invoices, correspondence, etc. The auditor should see that plant and machinery is properly depreciated.

10. Loose Tool, Patterns, Dies etc.: The auditor should examine the list of the loose tools. He should see that the list has been certified by a responsible officer.

11. Property: The auditor is not competent to examine the title deed relating to a property. In such a case he should insist upon the client to get a certificate regarding their validity from the solicitor. A certificate form an architect, surveyor or an engineer will also serve the purpose of the valuation of the property. The property may be (a) Freehold property (b) Lease hold property. In both case the auditor should examine the title deeds relating to the property.

12. Goodwill: Goodwill is defined as the assessed value of the reputation of a business or as the difference between the purchase price and the net assets which are purchased and the excess amount so paid, represents the goodwill acquired by the business. It is intangible asset. It value depends upon the earning capacity of the business and fluctuates accordingly. In case the Directors have debited the profit and loss account and credited the amount to the goodwill account, the auditor should object to this step especially when the action taken is likely to prejudice the interest on any class of shareholders. He should mention this fact in his report to the shareholders if such a step has been taken

1.7.7 VERIFICATION OF LIABILITIES:

Generally liabilities are valued at face value. Verification of liabilities is as important as that of assets because any under-statement or omission thereof would vitally affect the result of business and also the financial state of affairs. Usually liabilities are small in number and more or less fixed in nature and, as such, they offer less difficulties to an auditor than assets.

An auditor should see that all liabilities or obligations genuinely outstanding on the closing date even those omitted accidentally or deliberately are duly accounted for, that all credit balances shown by books are real liabilities and that there is no manipulation in regard thereto.

An auditor must be satisfied that liabilities recorded in books are real, omission, if any, of liabilities are accounted for and duly disclosed. In fact, an auditor would be liable for negligence if he fails to detect omission of liabilities [Westminster Road Construction Co. case. Auditor's report should be qualified for any omission of liability.

Important points regarding verification of liabilities are enumerated below. It may, however, be noted that a major portion of such verification would have already been done at the time of routine checking and vouching of the books of account. As an additional safeguard the auditor may obtain a certificate from some responsible officer stating that all liabilities have been fully taken into account.

Contingent Liabilities:

A contingent liability is an incidence which is conditional or contingent on the happening' of certain events. There is an element of uncertainty about this group of liabilities, which may or may not occur. Such a liability, if it eventually arises, involves payment of money in future.

The following are the main types of contingent liabilities:

(i) Liability in respect of bills discounted or accepted on behalf of other parties, but not matured.

(ii) Liability under guarantee or surety arrangements in favour of others.

(iii) Liability under incomplete contracts for which compensation may or may not have to be paid under forward contracts.

(iv) Liability under pending law suits, claims or taxation appeals.

(v) Liability in respect of unpaid calls on partly paid shares held.

(vi) Liability for accumulated arrear dividends on cumulative preference shares.

(vii) Liability for claims not acknowledged as debts.

(viii) Liability of members of a company limited by guarantee.

(ix) Possible personal liabilities of partners in a firm.

(x) Liability under guarantee(s) for loans taken by others.

(xi) Other uncertain financial liability.

If any liability under the aforesaid heads does not actually accrue on the date of the balance sheet it should be mentioned by way of a separate note on the liabilities side of the balance sheet, compulsorily in case of a company and preferably in other cases also—but the figures should not be extended to the money column.

The maturity of any contingent liability may arise from either acquisition of asset or incurring of loss. If, however, any of these liabilities is expected to cause an actual loss, adequate reserve should be provided for the same.

These items would usually be discovered in course of routine checking and vouching. It is also useful to check contracts, notices, lawyers' bills, minute books, bank letters, correspondence etc. and to hold discussions with clients.

As additional measure an auditor may secure from the client's solicitors, legal advisers or tax consultants particulars of pending suits, claims, appeals etc. and obtain a schedule of contingent liabilities certified by a responsible officer to the effect that all probable liabilities- under this head have been taken into account, as it may not be possible for the auditor to gain in the normal course of audit knowledge of all items of contingent liabilities. An auditor should see that proper notes re: contingent liabilities are incorporated in the balance sheet.

The above exercise by an auditor would ensure disclosure of 'true and fair view' of the profit or loss and of the state of affairs of an enterprise by the Profit and Loss Account and the Balance Sheet.

(ii) Auditor's duties re: Contingent Liabilities:

(1) Collect a schedule of contingent liabilities certified by a responsible officer.

(2) Check the items in the list with notes taken in course of routine checking and vouching.

(3) Gather copies of bills discounted, if any, from banks or other parties.

(4) Check bills receivable book with entries in bank pass book.

(5) Check payments against partly paid shares.

(6) Mention in report insufficient provision, if any, for any contingent liability

(7) Check computation of and reasons for unpaid dividend on cumulative preference shares.

(8) Ascertain all facts, justification and amount of contingent liabilities for pending law suits.

(9) Check correspondence, certificates from solicitors' lenders regarding contingent liability under guarantee(s) for loan(s).

(10) In case of a company verify compliance with provisions of Schedule VI to the Companies Act, 1956.

(11) Verify disclosure of contingent liabilities in the balance sheet.

Auditor's Duties towards Events taking Place after the Balance Sheet Date:

1. Analyse all relevant events to find out those relating to the balance sheet date in question.
2. Eliminate events not related to balance sheet date.
3. Correct the balance sheet by incorporating changes in value of assets and liabilities caused by events occurred after the balance sheet date according to the concept of "materiality".
4. Suitably revise the profit and loss account by altering provisions and reserves due to events occurred after the balance sheet dates.
5. Prepare and authenticate a special statement of reconciliation covering the above points.

1.7.7.1 VERIFICATION AND VALUATION OF DIFFERENT KINDS OF LIABILITIES:

1. 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. The auditor should examine the Memorandum of Association and the Articles of Association of the company. He should also examine the Cash Book, Pass Book and Minutes Book of the Board of Directors to find out the number and different classes of shares issued.

2. Reserve Accounts and Funds: For the audit of these two items, the auditor should examine the Minutes Books of directors meeting.

3. Debentures and Mortgage: The auditor should enquire in to powers of the company to borrow money.

4. Trade Creditors: The auditors should ask for schedule of the creditors and check it with the purchase ledger which in its turn may be checked with the books of original entry with the Purchase invoices, Credit Notes, Goods Inward Books, Return Outward Book, Bill Payable Book, and Cash Book. The Auditor should see that all

Purchase during the year have been included in the purchases and especially purchases made at the close of the year.

5. Bills Payable: The auditor should verify this item form Bills payable Book and the Bills Payable Account. The Bills payable already paid should be checked from the Cash Book and examine the returned bills payable. To see the genuineness of the bills payable in hand on the date of balance sheet, the auditor should check the cash book of the succeeding year as to whether any payment has been made in respect of such bills.

6. Outstanding Expenses: The auditor should get a certificate from a responsible official to see that all expenses for the current year are included and the payment for each expenses such as interest, discounts, salaries have not been paid are included.

7. Loans: Reference may be made to the agreement and correspondence for getting the loan. If interest on the loan has not been paid, he should see that it is shown as a liability. In case of bank overdraft, the agreement with the bank and the security offered should be examined.

8. Contingent Liability: The auditors should consider the circumstance and the situation about the occurrence of that type of liabilities.

1.7.8 Distinction between verification and valuation :

1. Meaning : verification establishes existence, ownership and acquisition of assets whereas valuation certifies correctness of the value of assets and liabilities.

2. Time : Verification is done at the end of the year whereas valuation is done during the year.

3. Personnel : Verification is done by auditor whereas valuation is done by the proprietor himself.

4. Evidence : The title deeds, receipts of payments constitute documentary evidence for verification where as certificate given by the proprietor is the documentary evidence for valuation.

2 **Summary**

1.7.9 Key Differences Between Vouching and Verification:

The following are the major differences between vouching and verification

1. Vouching is to check the vouchers, which are in support of the accounting entry. Verification means to validate the resemblance of facts regarding the assets and liabilities, with those appearing in the Balance Sheet.
2. Vouching is done on the basis of documentary evidence i.e. vouchers, invoices, bills or statements. On the other hand, thorough analysis and documentary evidence, are the pre-requisite of Verification.
3. In vouching, items of Income Statement are examined while verification is carried out for Balance Sheet items.
4. Vouching is performed throughout the year, but Verification is done only at the end of the financial year.
5. In general, Vouching is carried out by Audit Clerks or Audit Assistant whereas Verification requires deep observation and that is why auditor himself conducts it.
6. Vouching aims at testing the accuracy, completeness, and authenticity of transactions. Conversely, Verification focuses on confirming the ownership, possession, valuation and disclosure of the assets or liabilities.
7. Vouching considers incomes and expenses. As opposed to Verification, which is done for assets and liabilities.

1.7.9.1 Self check exercise- 2

1. Differentiate between verification and vouching.

1.7.10 Summary

The concept of verification is introduced in this chapter. Verification of various types of assets and liabilities has been provided. Along with that, valuation of assets and liabilities has also been discussed in this chapter.

1.7.11. Glossary

a) AS-Accounting Standard
b) BR- Bills Receivable

1.7.12. Questions for Exercise

1. What do you mean by verification? Distinguish clearly between verification and valuation and explain objectives of verification.

2. " An auditor is not a valuer." "An auditor is intimately connected with values." Explain fully how these two standards can be reconciled.
3. What are the duties of auditor regarding valuation of assets and liabilities?
4. Describe the process of verification of assets and liabilities.
5. Discuss fully recognised accounting principles governing valuation of inventories.
6. Explain clearly the meaning of 'verification of liabilities' as shown in a balance sheet.

1.7.13. Suggested Readings:

1. Auditing : Theory and Practice by Pardeep kumar
2. Auditing Principles and Problems by T.R. Sharma
3. Auditing in a Computerised Environment by Mohan, Bhatia
4. Fundamental of Practical Auditing by Ravinder Kumar, Varinder Sharma

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